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UNITED STATES TAX COURT

C.H. SMITH, Petitioner v. COMMISSIONER OF INTERNAL REVENUE,
Respondent

Docket No. 28047-81.

Filed June 4, 1986.

Leslie Shields, for the petitioner.

Cynthia M. Odle-Schlehty, for the respondent.

MEMORANDUM OPINION

WILBUR, Judge: Respondent determined a deficiency of \$49,596.72 in petitioner's Federal income taxes for 1977. The issue for decision is whether petitioner's contribution of property to the Oliver Springs Lions Club and Sight and Hearing

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Center, Inc. entitles him to claim a deduction under section 170.¹

This case has been submitted fully stipulated pursuant to Rule 122(a).² The evidence consists of a stipulation of facts with attached exhibits which is incorporated herein by this reference.

Petitioner, C.H. Smith, was a resident of Oliver Springs, Tennessee at the time he filed the petition in this case. Petitioner filed his individual income tax return for 1977 with the Director, Memphis Service Center, Memphis, Tennessee.

During 1977, petitioner was stockholder, president, and employee of Oliver Springs Mining Company. Petitioner was very active in business and community affairs in and around Oliver Springs and was a member of the Oliver Springs Lions Club. The Oliver Springs Lions Club (hereinafter the Club) leased a building for its meetings and activities. However, sometime prior to 1977, the Club was forced to seek other facilities because the lease was due to expire. In response to that need, petitioner sought to buy a piece of property for the sole purpose of contributing it to the Club.

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Unless otherwise indicated, all references to authority designated by section number are to the Internal Revenue Code of 1954 as amended and in effect during 1977.

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Unless otherwise indicated, all references to authority designated by rule number are to the Tax Court Rules of Practice and Procedure.

A suitable piece of property was located. The owner of the property, Mrs. E.C. Foster, was unwilling to sell unless the property would be used for charitable purposes. In 1976, petitioner purchased the property after assuring Mrs. Foster that the property would be used for charitable purposes. Petitioner then built a swimming pool and clubhouse on the property.

In anticipation of owning real estate, the Club, on the advice of a local attorney, decided to incorporate for the purpose of protecting its members from liability should someone be injured on the property. The Club formed a not-for-profit corporation under the laws of the state of Tennessee on August 5, 1977. The corporation was named the Oliver Springs Lions Club, Inc. Shortly thereafter, by an amendment to the corporate charter the name of the corporation was changed to the Oliver Springs Lions Club and Sight and Hearing Center, Inc. The amendment also changed the purposes for which the corporation was organized and listed them as follows:

To provide facilities for examination of eye and ear diseases, and to promote care, and treatment of eye and ear problems, and to promote activities for the blind and the deaf of the community, and to seek and obtain donors to eye bank, and to engage in such charitable activities as the TRUSTEES deem fit, and to promote the Corporation in the Oliver Springs area.

On December 28, 1977, petitioner transferred the property to the Oliver Springs Lions Club Sight and Hearing Center, Inc.³ with the following provision in the deed:

In the event that the Oliver Springs Lions Club and Sight and Hearing Center, Inc. should ever cease to function for its stated purpose, or any other charitable and civic purpose, then the title to the above property will be divested out of the Oliver Springs Lion Club and Sight and Hearing Center, Inc., and will be vested in the Beach Park Missionary Baptist Church.

The Oliver Springs Lions Club is a subordinate of the International Association of Lions Clubs and has thereby qualified as a section 501(c)(4) organization by group exemption letter. However, at no time before or after the incorporation of the Oliver Springs Lion Club and Sight and Hearing Center, Inc. was the Commissioner of the Internal Revenue notified of any change of name, form, character, purpose, or method of operation of the Oliver Springs Lions Club. No application for exempt status was ever filed during 1977, or thereafter, in the name of the Oliver Springs Lions Club, Inc., the Oliver Springs Lions Club Sight and Hearing Center, Inc., nor the Oliver Springs Lions Club and Sight and Hearing Center, Inc.

Petitioner concedes that the property transferred is capital gain property and that if it is otherwise a deductible charitable contribution, the deduction is limited to \$76,397 in 1977. Section 170(b)(1)(C). Petitioner further concedes that the

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Petitioner appears to use this name interchangeably with Oliver Springs Lions Club and Sight and Hearing Center, Inc. The deed of transfer executed by petitioner uses both names.

Oliver Springs Lions Club and Sight and Hearing Center, Inc. was not a qualified organization for purposes of section 170.

Section 170 generally provides a deduction for contributions to charitable organizations.⁴ However, section 170(f)(1) disallows a charitable deduction if the donee organization fails

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SEC. 170. CHARITABLE, ETC., CONTRIBUTIONS AND GIFTS.

(a) ALLOWANCE OF DEDUCTION.--

(1) GENERAL RULE.--There shall be allowed as a deduction any charitable contribution (as defined in subsection (c)) payment of which is made within the taxable year. A charitable contribution shall be allowable as a deduction only if verified under regulations prescribed by the Secretary.

* * *

(c) CHARITABLE CONTRIBUTION DEFINED.--For purposes of this section, the term "charitable contribution" means a contribution or gift to or for the use of--

* * *

(2) A corporation, trust, or community chest, fund, or foundation--

(A) created or organized in the United States or in any possession thereof, or under the law of the United States, any State, the District of Columbia, or any possession of the United States;

(B) organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provisions of athletic facilities or equipment), or for the prevention of cruelty to children or animals;

(C) no part of the net earnings of which inures to the benefit of any private shareholder or individual; and

(D) which is not disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

A contribution or gift by a corporation to a trust, chest, fund, or foundation shall be deductible by reason of this

(footnote continued)

to satisfy certain filing requirements for tax-exempt status.⁵
The regulations provide that a charitable organization must file a notice, described in section 508(a), within 15 months of the end of the month within which it is organized to qualify as an

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paragraph only if it is to be used within the United States or any of its possessions exclusively for purposes specified in subparagraph (B).

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Sec. 170(f) provides:

(f) DISALLOWANCE OF DEDUCTION IN CERTAIN CASES AND SPECIAL RULES.--

(1) IN GENERAL.--No deduction shall be allowed under this section for a contribution to or for the use of an organization or trust described in section 508(d) or 4948(c)(4) subject to the conditions specified in such sections.

Sec. 508(d) provides:

(d) DISALLOWANCE OF CERTAIN CHARITABLE, ETC., DEDUCTIONS.--
* * *

(2) GIFT OR BEQUEST TO TAXABLE PRIVATE FOUNDATION, SECTION 4947 TRUST, ETC.--No gift or bequest made to an organization shall be allowed as a deduction under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522, if such gift or bequest is made--
* * *

(B) to any organization in a period for which it is not treated as an organization described in section 501(c)(3) by reason of subsection (a).

Sec. 508(a) provides:

(a) NEW ORGANIZATIONS MUST NOTIFY SECRETARY THAT THEY ARE APPLYING FOR RECOGNITION OF SECTION 501(c)(3) STATUS.--Except as provided in subsection (c), an organization organized after October 9, 1969, shall not be treated as an organization described in section 501(c)(3)--

(1) unless it has given notice to the Secretary, in such manner as the Secretary may by regulations prescribe, that it is applying for recognition of such status, or
(footnote continued)

exempt organization from its beginning. Section 1.508-1(a)(2)(i), Income Tax Regs. The Oliver Springs Lions Club and Sight and Hearing Center, Inc. has never filed such an application.

The Oliver Springs Lions Club was an unincorporated subordinate of the International Association of Lions Clubs and qualified as a section 501(c)(4) exempt organization under that association's group exemption letter.⁶ Upon incorporation, however, the Oliver Springs Lions Club and Sight and Hearing Center, Inc. became a separate entity for purposes of the tax

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(2) for any period before the giving of such notice, if such notice is given after the time prescribed by the Secretary by regulations for giving notice under this subsection.

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26 C.F.R. sec. 601.201 (1977) provides, in part:

RULINGS AND DETERMINATIONS LETTERS.

* * *

(n) ORGANIZATION CLAIMING EXEMPTION UNDER SECTION 501 or 521 OF THE CODE

* * *

(7) Group exemption letters--(i) General. (a) A group exemption letter is a ruling issued to a central organization recognizing on a group basis the exemption under section 501(c) of the Code of subordinate organizations on whose behalf the central organization has applied for exemption in accordance with this subparagraph.

(b) A central organization is an organization which has one or more subordinates under its general supervision or control.

(c) A subordinate is a chapter, local, post, or unit of a central organization. It may or may not be incorporated. A central organization may be subordinate itself, such as a state organization which has subordinate units and is itself affiliated with a national organization.

(d) A subordinate included in a group exemption letter should not apply separately for an exemption letter, unless it no longer wants to be included in the group exemption letter.

laws. Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943). As such, the center was not covered by the International Association's group exemption letter.⁷ Respondent also correctly points out that although an organization may be exempt from income taxation under section 501(c)(4), contributions to such an organization are not deductible under section 170.⁸ Regan v.

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A group exemption letter only covers subordinates that are in existence at the time of its issuance. The Oliver Springs Lions Club and Sight and Hearing Center, Inc., being a new and separate entity, cannot, therefore, claim to be covered by the group exemption letter.

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Much of the language of sec. 170(c)(2) parallels language used in sec. 501(c)(3):

SEC. 501. EXEMPTION FROM TAX ON CORPORATIONS, CERTAIN TRUSTS, ETC.

(a) EXEMPTION FROM TAXATION.--An organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502 or 503.

* * *

(c) LIST OF EXEMPT ORGANIZATIONS.--The following organizations are referred to in subsection (a):

* * *

(3) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any

(footnote continued)

Taxation with Representation of Wash., 461 U.S. 540, 543 (1983);
Alexander v. "Americans United" Inc., 416 U.S. 752, 755 (1974).

Conceding the above, petitioner contends that the language of the deed of transfer and the references therein created a charitable trust which qualifies under section 4947(a)(1). Petitioner further contends that a section 4947(a)(1) charitable trust is not subject to the 15 months' notice requirement of the regulations and is not required to have tax exempt status under section 501(c)(3) in order to be a qualified organization for purposes of section 170. Petitioner concludes that because the requirements of section 53.4947-1(b), Excise Tax Regs., and section 170(c)(2)(B) were satisfied by the charitable trust, the transfer of the property qualified as a deductible charitable contribution.

Conversely, respondent contends that this case involves merely a transfer of property by a simple deed which provided for a forfeiture in favor of another party upon the occurrence of a

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candidate for public office.

(4) Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare, or local associations of employees, the membership of which is limited to the employees of a designated person or persons in a particular municipality, and the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes.

Sec. 501(c)(4) organizations include organizations involved in civic non-charitable activities. Sec. 501(c)(3) organizations include only charitable organizations.

stated event. Respondent also contends that even if a trust had been created, section 4947 has no application to a determination under section 170 as to whether a charitable deduction will be allowed, and further, that even if section 4947 were so applicable, its requirements would not be satisfied in this case. We agree with respondent that a trust was not created by the deed of transfer, and we therefore do not reach any of the other contentions.

As a general proposition, "[g]rantees under deeds, wills and trusts, alike, take according to the rule of the state law." Helvering v. Stuart, 317 U.S. 154, 161 (1942). A donor's disposition of property in the state of his residence is subject to its laws. By that law the character of a trust and the nature and extent of the donee's interest are to be determined. Blair v. Commissioner, 300 U.S. 5, 9-10 (1937). Under the Supreme Court's holding in Commissioner v. Estate of Bosch, 387 U.S. 456, 465 (1967), an interpretation of state law by the state's highest court is to be followed where the underlying substantive rule is based on that law. In this case we look to the law of the state of Tennessee, as interpreted by the Supreme Court of Tennessee, to determine whether the deed of transfer created a trust.

In the case before us, the restrictions in the deed of transfer are stated in a form which is standard for the transfer of a fee simple subject to an executory interest. Burby, Real Property, sec. 92, p. 209 (3d ed. 1965). Petitioner contends,

however, that the language of the deed and references therein created a charitable trust. The restriction in the deed of transfer states:

In the event that The Oliver Springs Lions Club and Sight and Hearing Center, Inc. should ever cease to function for its stated purpose, or any other charitable and civic purpose, then the title to the above property will be divested out of the Oliver Springs Lions Club and Sight and Hearing Center, Inc., and will be vested in the Beach Park Missionary Baptist Church. [Emphasis added.]

The purpose clause in the charter of the Oliver Springs Lions Club and Sight and Hearing Center, Inc. lists its purpose as follows:

To provide facilities for examination of eye and ear diseases, and to promote care, and treatment of eye and ear problems, and to promote activities for the blind and deaf of the community, and to seek and obtain donors to eye bank, and to engage in such charitable activities as the TRUSTEES deem fit, and to promote the Corporation in the Oliver Springs area.

Petitioner argues that the intent to create a trust is evidenced by the fact that, under the terms of the deed, the property would divest out of the Center if it ceases to function "for its stated purpose, or any other charitable and civic purpose" and that the referenced purpose clause uses the term "trustee."

Tennessee law favors trusts of a charitable nature and will often uphold them in situations in which a trust of an ordinary and private nature would fail. Ratto v. Nashville Trust Co., 178 Tenn. 457, 159 S.W. 2d 88, 90 (1942). However, the Supreme Court of Tennessee has stated that:

There is a broad distinction between a gift direct to a charity or charitable institutions already established, and a gift to a trustee, to be by him applied to a charity. In the first case the court has only to give the fund to the charitable

institution, which is merely a ministerial or prerogative act; but in the latter case the court has jurisdiction of the trustee, as it has over all trustees, to see that he does not commit a breach of his trust, or apply the funds, in bad faith, to purposes foreign to the charity.* * * [Johnson v. Johnson, 92 Tenn. 559, 23 S.W. 114, 116 (1893).]

Without strong evidence that such was the intent of the donor, it is unlikely that Tennessee law would characterize a deed as being a transfer in trust when on its face it appears to be a direct charitable gift. We also note that the normal result of a trustee's failure to carry out a trust is court enforcement of the trust, as opposed to a forfeiture such as is required by the deed in this case.

The reference in the deed to the center's purpose is the only evidence we find potentially suggestive of an intent to create a trust. However, the deed does not specifically reference the charter's purpose clause⁹ and there is no evidence that petitioner was aware that the purpose clause used the term "trustee." The form of the deed creates a presumption that it was intended to transfer a direct gift with a provision for forfeiture upon failure to use the property for the stated purposes. The evidence in this case is clearly insufficient to overcome this presumption.

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The deed refers to the Center's "stated purpose."

In conclusion, petitioner's arguments have not convinced us that the deed of transfer created a charitable trust. We accordingly hold that petitioner's contribution of property to the Oliver Springs Lions Club and Sight and Hearing Center, Inc. did not entitle him to claim a deduction under section 170.

Decision will be entered
for the respondent.

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T. C. Memo. 1986-225

UNITED STATES TAX COURT

ALAN K. AND PATRICIA M. HARRIS, Petitioners v. COMMISSIONER OF
INTERNAL REVENUE, Respondent

Docket No. 15508-82.

Filed June 4, 1986.

Petitioner reported income and expenses with respect to the raising, breeding and training of horses. Petitioner timely filed an election to postpone until the close of the sixth taxable year of such activity the determination of whether it should be presumed that he was engaged in such activity for profit.

Held, petitioner has failed to demonstrate that he realized a net gain in any year of such activity, so that the presumption under section 183(d), I.R.C. 1954, is inapplicable. Held further, petitioner has failed to demonstrate that such activity did not constitute an activity "not engaged in for profit," within the meaning of section 183, so that expenses properly attributable to such activity are deductible only to the extent allowable under section 183(b).

James W. Wessel, for the petitioners.

Jerry Lanting Leonard, for the respondent.

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MEMORANDUM FINDINGS OF FACT AND OPINION

STERRETT, Chief Judge: Respondent determined by notices of deficiency dated April 6, 1982 and June 10, 1982 for the taxable years ended December 31, 1978 and December 31, 1979, respectively, deficiencies in petitioners' Federal income taxes as follows:

<u>Taxable Year</u> ¹	<u>Deficiency</u>
1978	\$3,539.24
1979	3,038.00

The sole issue for decision is whether petitioners' raising, breeding and training of horses constituted an activity "not engaged in for profit" within the meaning of section 183.²

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulated facts and exhibits attached thereto are incorporated herein by this reference.

Petitioners Alan K. Harris and Patricia M. Harris, husband and wife, resided in Gardnerville, Nevada at the time they filed their petition in this case. Petitioners filed joint Federal income tax returns with the Internal Revenue Service for the 1978

¹ In their petition, petitioners contested deficiencies purportedly determined in their Federal income taxes for the 1978, 1979, and 1980 taxable years. By order of the Chief Judge, dated September 7, 1982, this Court granted respondent's motion to dismiss this case for lack of jurisdiction insofar as it related to the 1980 taxable year.

² Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the taxable years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

and 1979 taxable years. All references to petitioner in the singular or to "petitioner husband" refer to petitioner Alan K. Harris, and all references to "petitioner wife" refer to petitioner Patricia M. Harris.

During the taxable years in issue, petitioner wife worked as a Christian Science practitioner, and reported net losses from this business of approximately \$3,100 and \$4,600 for 1978 and 1979, respectively. In these same years, petitioner husband was employed as an airline pilot by United Air Lines, Inc., and received approximately \$45,000 per year in wages as an airline pilot.³ On his 1978 and 1979 Federal income tax returns petitioner husband listed his occupations as a pilot and as a horse breeder.

In the spring of 1974, petitioners purchased certain land located in Gardnerville, Nevada for \$95,000. The land consisted of a 5-1/2 acre farm with a house and a 4-stall stable. Petitioner constructed fences, added a small toolshed, and installed an irrigation system on the property.

Between 1974 and 1978 petitioner investigated the horse breeding business by speaking to local people, attending horse shows, and reading on the subject. Among the individuals with whom petitioner spoke were one horse trainer and rider, and two breeders of Appaloosa horses.

³ For the 1980 through 1983 taxable years, petitioner husband's income for wages as an airline pilot steadily rose from approximately \$68,000 to \$98,000.

From 1974 until 1978 petitioners purchased several horses. In 1974 petitioner husband acquired an old palomino named "Nugget." In 1975 petitioner wife purchased a tentatively registered 5-year old pinto gelding, "Kerri's Sonny Boy," for \$1,500, which died in 1980. In 1976 petitioner purchased a registered Appaloosa stallion, "Apache Totah," for \$500. In 1977 he purchased an unregistered sorrel gelding and an unregistered palomino gelding, each for \$400. In 1978 petitioner purchased a registered Appaloosa mare, the dam of Apache Totah, named "Star Boys Go Go," and her foal for \$700. In 1980 petitioner executed a breeding contract to breed this mare, and the foal was born in March 1981. However, the official records of the Appaloosa Horse Club do not list the mare as having been mated with any registered Appaloosa stallion since May 1977.

After the 1980 taxable year, petitioner was audited by the Internal Revenue Service with respect to his horse breeding activity, conducted under the name of "Five Square Appaloosa." Petitioner timely filed an election to postpone until 1983 the determination of whether it should be presumed that, since 1978, he was engaged in this activity for profit.⁴ Petitioner then compiled records of his income and expenses for 1978 and 1979. Thereafter, petitioner kept records with respect to the horse breeding activity and entered his records into ledgers in the January or February following the close of each calendar year, in preparation of his tax returns.

⁴ See subsections (d) and (e) of section 183.

On his Federal income tax returns, Schedule F, Farm Income and Expenses, for the following taxable years, petitioner reported amounts attributable to such horse breeding activity as follows:

<u>Year</u>	<u>Gross Income</u>	<u>Deduction</u>	<u>Net Gain</u>	<u>Net Loss</u>
1978	\$ 130.00	\$ 9,483.08	--	\$ 9,353.08
1979	120.00	12,467.58	--	12,347.58
1980	180.00	16,807.35	--	16,627.35
1981	--	16,634.86	--	16,634.86
1982	--	15,721.05	--	15,721.05
1983	<u>8,500.00</u>	<u>8,181.00</u>	<u>\$319.00</u>	<u>--</u>
Totals	\$8,930.00	\$79,294.92	\$319.00	\$70,683.92

The only year in which petitioner reported a net gain with respect to the horse breeding activity was 1983. The \$8,500 amount of gross income reported in 1983 was derived entirely from sales of horses to Anthony R. Abbott (Abbott). Petitioner reported \$1,800 in income, on the sale of the sorrel gelding on January 20, 1983 for \$800, and on the sale of the palomino gelding on February 15, 1983 for \$1,000. Petitioner did not reduce the amount of the income reported by his \$800 cost, that is, \$400 each, for these two horses.

The remaining \$6,700 in income reported for 1983 was based upon a document, labeled "Demand Note" (the note), executed on September 1, 1983 between petitioner, as seller, and Abbott, as buyer, for the sale of a registered Appaloosa horse named "Summer Ice."⁵ The note provided that Abbott was "to pay on demand" to

⁵ The record does not indicate whether "Summer Ice" is the foal born to "Star Boys Go-Go" in March 1981, or a different horse acquired by petitioner at some other time. Therefore, any
(footnote continued)

petitioner the amount of \$5,500, plus \$300 per month for a minimum of 6 months, for training and boarding expenses for this horse. The \$6,700 amount is the sum of the \$5,500 face amount of the note, plus \$1,200 for expenses, that is, \$300 per month from September through December 1983. The note further provided that petitioner was to retain possession of the horse until the terms of the note were satisfied in full. As of the date of trial, petitioner had not been paid the \$5,500 face amount of the note nor any of the additional monthly payments, and still retained possession of the horse.

For the taxable years from 1978 through 1983, petitioner deducted various expenses attributable to the horse raising, breeding, and training activity. In 1980 petitioner claimed a loss in the amount of \$1,500 upon the death of "Kerri's Sonny Boy." Petitioner also deducted \$300 per month from September 1983 through February 1984 for training and boarding expenses for "Summer Ice," pursuant to the terms of the note as stated above. Petitioner claimed depreciation expenses for the horses, barn, fences, corrals, machinery and equipment, toolshed, truck and horse trailer. Also among the expenses reported with respect to such activity were costs for motels, meals, parking and other travel expenses to San Francisco, California incurred by petitioner with respect to his occupation as an airline pilot.

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acquisition costs incurred by petitioner with respect to this horse are not clear from the record.

Petitioner did not list Five Square Appaloosa in any telephone directory, and, after 1976, did not subscribe to, nor advertise in, the "Appaloosa News," the official magazine of the Appaloosa Horse Club. Petitioner did not advertise his horses on any regular basis, and did not enter them in any horse shows.

In the statutory notices of deficiency, respondent determined deficiencies in petitioners' Federal income taxes for the 1978 and 1979 taxable years. The deficiencies determined were based upon respondent's disallowance of deductions for expenses claimed with respect to petitioner's raising, breeding and training of horses, which respondent determined to be an activity not engaged in for profit.

OPINION

The sole issue for decision is whether respondent has correctly disallowed deductions taken by petitioner based on the determination that petitioner's raising, breeding and training of horses was an activity "not engaged in for profit" within the meaning of section 183. Section 183(a) provides the general rule that, in the case of an activity by an individual not engaged in for profit, no deduction attributable to such activity shall be allowed except as provided in section 183(b). Section 183(b)(1) provides that there shall be allowed those deductions that would be allowable without regard to whether or not the activity is engaged in for profit. See sec. 1.183-1(b), Income Tax Regs. Section 183(b)(2) provides that deductions that would be allowable only if the activity were engaged in for profit shall

be allowed to the extent that the gross income derived from the activity exceeds the deductions allowable under paragraph (1) of section 183(b). Section 183(c) defines an activity not engaged in for profit as follows:

Activity Not Engaged in for Profit Defined.--For purposes of this section, the term "activity not engaged in for profit" means any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212.

Section 183(d) provides that, in the case of an activity which consists in major part of the breeding, training, showing, or racing of horses, if the gross income derived from such activity exceeds the deductions therefrom for any 2 of 7 consecutive taxable years, then such activity shall be presumed to be engaged in for profit, unless the Secretary establishes to the contrary.

Respondent has determined that petitioner's horse breeding activity was not engaged in for profit, and therefore, that petitioner's deductions for expenses incurred with respect to such activity must be limited in accordance with section 183(b). Petitioner argues that it should be presumed that the activity was engaged in for profit in accordance with section 183(d), and, in any event, that he is entitled to all of the deductions claimed as attributable to the horse breeding activity because he possessed the requisite intention of making a profit. Petitioner bears the burden of proof. Rule 142(a); Golanty v. Commissioner, 72 T.C. 411, 426 (1979), affd. without published opinion 647 F.2d 170 (9th Cir. 1981).

Presumption Under Section 183(d)

The parties have stipulated that petitioner timely elected, in accordance with section 183(e), to postpone until the close of the sixth taxable year of the activity the determination of whether the presumption under section 183(d) shall apply to his horse breeding activity. Petitioner contends that he was engaged in the raising, breeding and training of horses as of 1978, so that the sixth taxable year of the activity refers to 1983. Petitioner does not dispute that he incurred a net loss from the activity in each of the five taxable years from 1978 through 1982. Therefore, in order for the presumption to apply, petitioner must demonstrate in the first instance that for 1983, as the first of 2 years of net gain within the 7 consecutive taxable year period, gross income derived from the horse breeding activity exceeded deductions therefrom.⁶ Cf. Moore v. Commissioner, 85 T.C. 72, 112-113 (1985).

In the 1983 taxable year, petitioner reported a net gain of \$319 from the horse breeding activity, based upon gross income in the amount of \$8,500 from the sales of three horses. Petitioner reported \$1,800 in gross income from the sales of two geldings, at \$800 and \$1,000, respectively. However, the amount of the

⁶ We note that 1984, the seventh consecutive taxable year of the activity, is not before the Court. However, in light of our conclusion that there was no net gain in 1983, we need not speculate whether petitioner might have realized a net gain in that seventh year.

actual gross income on these sales should have been reduced by petitioner's \$800 combined costs of these horses. Sec. 1.61-4(a), Income Tax Regs. See also sec. 1.183-1(e), Income Tax Regs.

The remaining \$6,700 reported in income for 1983 was based on a "Demand Note" executed on September 1, 1983 for the sale of an Appaloosa horse. As of the date of trial, petitioner had not received any payments with respect to this note, and still retained possession of the horse. The note merely represents a promise by a third party to make payments to petitioner at some uncertain future date, at which time petitioner would then transfer possession of the horse. A mere promise to make future payments is not properly includable in income. Ennis v. Commissioner, 17 T.C. 465, 470 (1951). Therefore, petitioner has overstated his income for 1983 based on the note, and, in fact, had incurred a loss with respect to his horse breeding activity in this year as well.⁷

Based on the foregoing, we find that petitioner has failed to demonstrate that he derived a net gain in 1983 from this activity. Accordingly, we conclude that the presumption under

⁷ Respondent argues that the note does not constitute income to petitioner either because it does not satisfy the "cash equivalency test," or alternatively, because the note's fair market value is less than its face value, citing Warren Jones Company v. Commissioner, 524 F.2d 788 (9th Cir. 1975). Based on our conclusion that the note represents a mere promise to make future payments, we need not address these arguments.

We also note that petitioner's 1978 and 1979 taxable years only are properly before the Court. Therefore, we need not discuss whether petitioner may be entitled to any adjustment in his Federal income tax liability in any subsequent taxable year as a result of these improper inclusions in gross income.

section 183(d) is inapplicable. However, petitioner's failure to qualify for this presumption does not give rise to any inference that the activity was not engaged in for profit. Sec. 1.183-1(c)(1), Income Tax Regs. Therefore, we next must consider whether petitioner engaged in this activity with the objective of making a profit.

Profit Objective

Petitioner maintains that since 1978 he has been in the business of raising, breeding, and training Appaloosa horses with the intent of making a profit, within the meaning of section 183. It is not necessary that petitioner's expectation of making a profit be reasonable, so long as he possessed a bona fide objective of realizing a profit. Sec. 1.183-2(a), Income Tax Regs.; Golanty v. Commissioner, 72 T.C. at 425-426; Besseney v. Commissioner, 45 T.C. 261, 274 (1965), affd. 379 F.2d 252 (2d Cir. 1967). It must be determined whether petitioner possessed an "actual and honest profit objective," Dreicer v. Commissioner, 78 T.C. 642, 645 (1982), affd. without opinion 702 F.2d 1205 (D.C. Cir. 1983).

The question of whether petitioner entered into, and continued to engage in, the horse breeding activity with the intention of making a profit is a question of fact. Golanty v. Commissioner, 72 T.C. at 426. Greater weight is accorded to objective facts than to petitioner's statements of his intent. Sec. 1.183-2(a), Income Tax Regs.; Engdahl v. Commissioner, 72 T.C. 659, 666 (1979). Section 1.183-2(b), Income Tax Regs.,

lists the following nine factors to be considered, along with all of the surrounding facts and circumstances, in determining whether an activity is engaged in for profit:

- (1) the manner in which the taxpayer carries on the activity;
- (2) the expertise of the taxpayer or his or her advisors;
- (3) the time and effort expended by the taxpayer in carrying on the activity;
- (4) the expectation that assets used in the activity may appreciate in value;
- (5) the success of the taxpayer in carrying on other similar or dissimilar activities;
- (6) the taxpayer's history of income or losses with respect to the activity;
- (7) the amount of occasional profits earned, if any;
- (8) the financial status of the taxpayer;
- (9) elements of personal pleasure or recreation involved in the activity.

Petitioner contends that the requisite profit motive is evidenced by the preparation undertaken with respect to the horse breeding activity prior to 1978, including his reliance upon the advice of individuals whom he considered to be experts in the field, and the time and effort he expended in the activity. Although there may be some merit to petitioner's arguments, we conclude that, taken as a whole, the facts of this case do not support petitioner's position as discussed more fully below.

Petitioner testified at trial that between 1974 and 1978 he investigated the horse breeding business by attending horse shows, reading on the subject, and speaking to local people. Petitioner spoke with a horse trainer and rider and two breeders of Appaloosa horses before he decided to raise, breed, and train Appaloosa horses. Although petitioner has not introduced any

evidence to support his claim that the individuals consulted are experts in their fields, we do not doubt that he believed them to be so qualified.

Petitioner further testified that during the taxable years in issue he worked as an airline pilot for approximately 12-15 days per month and devoted the remainder of his time and efforts to his horse breeding activity. Petitioner stated that he personally performed repairs on the farm and that he and his son tended to the horses. Petitioner also stated that, although he enjoys riding horses, he did not have much time for riding, and furthermore that he did not consider his activities on the farm to be recreational or for pleasure.

Petitioner also contends that the manner in which he conducted the horse breeding activity supports his position. Petitioner maintains that he kept complete and accurate records of income and expenses attributable to the horse breeding activity. Although he recorded his income and expenses into ledgers after the close of each calendar year, it appears that petitioner merely transferred these records from other notations compiled throughout each year.

Petitioner further contends that the profit motive is evidenced by his anticipated appreciation in the value of assets used in the activity, particularly the value of the farm land. The land was purchased in 1974 at \$95,000. Petitioner testified that as of the date of trial the land was valued at \$147,500-\$150,000. However, petitioner has failed to introduce any

evidence to support this valuation. Also, it appears that petitioner has not treated all of the land as an asset of the horse breeding activity. For example, on Schedule F of his 1978 and 1979 returns, petitioner deducted as expenses attributable to the horse breeding activity only the interest, taxes, insurance and depreciation expenses allocated to the barn and corrals, rather than the full amount of these expenses incurred upon the entire piece of property. Therefore, although an expectation of appreciation in the value of land used in an activity may be considered in a taxpayer's intention to derive a profit, sec. 1.183-2(b)(4), Income Tax Regs., any holding of the farmland by petitioner for profit should be considered to be an activity separate from petitioner's horse breeding activity. See sec. 1.183-1(d)(1), Income Tax Regs.⁸

Another factor that also weighs against petitioner is the history of losses incurred with respect to this activity. In each year from 1978 through 1982 petitioner reported a net loss, in amounts ranging from approximately \$9,000 to \$16,000. Only in 1983 did petitioner report a net gain, of merely \$319, upon the sales of three horses. However, as discussed above, the gross income reported in 1983 is overstated because petitioner failed to reduce the income reported by his \$800 cost of two of the

⁸ Boddy v. Commissioner, T.C. Memo. 1984-156, affd. without published opinion 756 F.2d 884 (11th Cir. 1985).

horses sold, and because he reported \$6,700 in income from the sale of the third horse, which amount was not received in 1983 nor as of the date of trial.

Although losses in the initial years of an activity are not necessarily fatal to the section 183 determination, sec. 1.183-2(b)(6), Income Tax Regs., the ultimate goal of an activity engaged in for profit must be to realize a net profit on the activity so as to recoup losses sustained previously. Bessenvey v. Commissioner, 45 T.C. at 274. Petitioner has not indicated any changes made in this activity over the 1978-1983 period that might have supported an intent to improve its profitability. For example, with respect to the breeding aspect of this activity, it must be noted that petitioner owned only one mare, and from 1978 to 1983 only had her bred once. Also, the foal born to this mare is the only horse petitioner acquired after 1978, the year in which petitioner purports to have commenced to engage in this activity for profit.

We also note that petitioner did not list the purported business, Five Square Appaloosa, in any telephone directory, and did not advertise his horses on any regular basis nor enter them in any horse shows. Also, the fact that petitioner had substantial income from his occupation as an airline pilot, coupled with the considerable tax benefits realized from this activity, tends to indicate that the horse breeding activity was

not entered into, or continued to be engaged in, for profit. See sec. 1.183-2(b)(8), Income Tax Regs.; Golanty v. Commissioner, 72 T.C. at 428-429.

Upon review of the entire record, we conclude that petitioner has failed to carry his burden of proof that his raising, breeding and training of horses did not constitute an activity "not engaged in for profit" within the meaning of section 183.

It also must be noted that petitioner has deducted, as expenses attributable to the horse breeding activity, costs for motels, meals, parking, and other travel expenses incurred with respect to his occupation as an airline pilot. Petitioner argues that these expenses constitute deductible travel expenses between his two businesses as a pilot and as a horse breeder. Inasmuch as petitioner's horse breeding activity does not constitute a "business" we reject petitioner's argument.⁹ Accordingly, petitioner's deductions for expenses properly attributable to his horse breeding activity are limited to the extent allowable under section 183(b).

Decision will be entered
for the respondent.

⁹ On brief, petitioner stated that his employment as an airline pilot was based in San Francisco, California. Therefore, it appears that these travel costs represent nondeductible expenses incurred with respect to petitioner's commuting between his personal residence in Nevada and his tax home in California. Commissioner v. Flowers, 326 U.S. 465 (1946). In either event, petitioner has failed to carry his burden of proof that he is entitled to deduct these expenses.

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ORIGINAL

T. C. Memo. 1986-226

UNITED STATES TAX COURT

COLONIAL AMERICAN LIFE INSURANCE COMPANY, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 20384-83.

Filed June 4, 1986.

Thomas G. Nash, Jr., for the petitioner.

Seymour I. Sherman, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

WRIGHT, Judge: Respondent determined deficiencies of \$168,031.01 and \$197,481.99 in petitioner's Federal income taxes for 1975 and 1976, respectively. After concessions by the parties, the issue remaining for decision is whether the ceding commission paid by a reinsuring company to an initial insurer

under contracts for indemnity reinsurance may be deducted currently by the reinsuring company or must be amortized over the anticipated useful life of the policies reinsured.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. For purposes of clarity, the general principles concerning reinsurance are incorporated in the findings of fact.

Petitioner, Colonial American Life Insurance Company (Colonial), was incorporated in 1924 in the State of Louisiana. Its principal place of business at all relevant times was in New Orleans, Louisiana. Petitioner timely filed Federal income tax returns for the calendar years 1975 and 1976.

At all relevant times petitioner was authorized to and did engage in the insurance business in Louisiana and in numerous other states, writing various forms of life, accident, and health insurance. Petitioner's principal insurance risks during the years in controversy consisted of life contingencies originally written by it or written by other companies and reinsured by petitioner.

Reinsurance is an arrangement whereby an insurance company transfers some or all of the risks it has underwritten to another insurance company.¹ The company purchasing the reinsurance is

¹ An insurance company may want to reinsure its risks for a number of reasons including the diversification of its business, the acquisition of another insurance company indirectly through the acquisition of its business, the avoidance of a concentration of risk in one geographic area or line of business, and relief

(footnote continued)

known as the initial insurer, the reinsured, or the ceding company; the company acquiring the risk is known as the reinsurer or the reinsuring company.

There are basically two types of reinsurance -- assumption reinsurance and indemnity reinsurance. In assumption reinsurance, the reinsuring company takes over for the initial insurer and becomes directly liable to the policyholders. The initial insurer is relieved of all liability, including the maintenance of the required reserves. The reinsuring company has the duty of establishing and maintaining the required reserves. In addition, the reinsuring company is entitled to all premiums paid and must pay all future claims and expenses with respect to the policies.

With respect to indemnity reinsurance, two variations are relevant here: conventional coinsurance (hereinafter "coinsurance") and modified coinsurance (hereinafter "modified coinsurance"). In contrast to assumption reinsurance, under coinsurance and modified coinsurance, the initial insurer and the reinsuring company share the benefits and obligations arising out of the reinsured policy or contract. The initial insurer transfers to the reinsuring company all or part of its liability on the policies being reinsured, but it remains directly liable

(footnote continued from previous page)
from the surplus drain that may occur as a result of the heavy expenses and the necessity of establishing reserves connected with newly written policies.

to the policyholders and continues to collect premiums and to pay claims and expenses. The reinsuring company must reimburse the initial insurer for the claims and expenses which are paid by the initial insurer and which are attributable to the risks it has reinsured.

Coinsurance and modified coinsurance differ, however, in their effect on the reserves of the insurance companies involved. Essentially, reserves are liability accounts representing the present value of the company's net liabilities under the policies in force. Life insurance companies are required to maintain reserves in an amount equal to the excess of the present value of future benefits payable under the policies over the present value of future net premiums. Such liability must be backed by cash or other assets of the insurance company. In a coinsurance transaction, the initial insurer reduces its reserves attributable to the ceded liability and the reinsuring company must establish reserves to cover the liability acquired. In a modified coinsurance transaction, however, the initial insurer maintains the required reserves and merely collects and pays over to the reinsurer the investment income derived from the assets supporting the reserves. Although the initial insurer does not release the reserves and underlying assets, upon the parties'

consent to treatment under section 820,² the retention of assets and maintenance of reserves by the initial insurer are treated as custodial on behalf of the reinsuring company. Thus, for Federal tax purposes, in both coinsurance and modified coinsurance transactions, the same shift of reserves from the initial insurer to the reinsuring company takes place.

In coinsurance and modified coinsurance two exchanges take place: (1) the initial insurer pays the reinsuring company full consideration for the reserve liability assumed, and (2) the reinsuring company pays the initial insurer a "ceding commission" or an "initial allowance" for the business acquired. Insurance companies typically net these transactions, with only the excess amount changing hands. Thus, the reinsuring company has income equal to the reserve liability actually assumed even though such liability exceeds the consideration actually received.

In 1975, petitioner entered into two reinsurance transactions, one on a coinsurance basis and the other on a modified coinsurance basis, with respect to policies of life insurance originally written by Transport Life Insurance Company (Transport), with petitioner as the reinsuring company and Transport as the initial insurer or ceding company. Petitioner and Transport consented, with respect to the modified coinsurance

² All section references and reference to the "Code" are to the Internal Revenue Code of 1954, as amended and in effect during the year in issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

transaction, to application of the rules for the optional treatment of policies reinsured therein provided by section 820 and the regulations thereunder.

The coinsurance agreement provided for the payment by petitioner to Transport of an initial consideration or ceding commission in the amount of \$60,000, and a payment by Transport to petitioner of an amount equal to the mean reserves attributable to the risks reinsured. The modified coinsurance agreement provided for the payment by petitioner to Transport of an initial consideration in the amount of \$620,000. The accounting between the two companies with respect to the foregoing transactions (excluding interest) was as follows:

	<u>Coinsurance</u>	<u>Modified Coinsurance</u>
Reserves Transferred	\$ 675,762	\$ -0-
Ceding Commission	<u>60,000</u>	<u>620,000</u>
Amount Due Transport	(\$ 615,762)	\$620,000

In 1976, petitioner as reinsurer and Transport as ceding company entered simultaneously into two further reinsurance transactions with respect to the same policies, which policies belonged to the same groups or blocks of policies affected by the 1975 reinsurance transactions described above. The 1976 coinsurance agreement provided for the payment of an initial consideration by petitioner to Transport of \$72,000, and a payment by Transport to petitioner of an amount equal to the mean

reserves attributable to the risks reinsured. The 1976 modified coinsurance agreement provided for the payment by petitioner to Transport of an initial consideration in the amount of approximately \$780,000. The accounting between the companies with respect to the foregoing transactions (excluding interest) was as follows:

	<u>Coinsurance</u>	<u>Modified Coinsurance</u>
Reserves Transferred	\$ 851,398	\$ -0-
Ceding Commission	<u>72,000</u>	<u>780,000</u>
Amount due Transport	(\$ 779,398)	\$780,000

During 1975, petitioner paid a "finders fee" of \$13,600 with respect to its reinsurance transactions with Transport, and deducted this sum as an expense.

In his statutory notice of deficiency, respondent determined that the excess amounts of the required reserves over the cash received by petitioner³ were attributable to the acquisition of an intangible asset with an indeterminate useful life and were

³ These amounts were determined as follows:

<u>1975</u>	<u>Coinsurance</u>	<u>Modified Coinsurance</u>	<u>Total</u>
Reserves required	\$675,762	\$620,000	
Recd. by Petitioner	<u>615,762</u>	<u>-0-</u>	
Excess	\$ 60,000	\$620,000	\$680,000
<u>1976</u>			
Reserves required	\$851,398	\$780,000	
Recd. by Petitioner	<u>779,398</u>	<u>-0-</u>	
Excess	\$ 72,000	\$780,000	\$852,000

not deductible. Alternatively, respondent determined that such excess amounts were attributable to the cost of acquiring assets and must be amortized over their estimated life. He capitalized such amounts and restored them to petitioner's income, but allowed no amortization because the reasonable estimated life of those assets had not been established. He also included those amounts in the computation of petitioner's assets for the taxable years 1975 and 1976, respectively.

Respondent disallowed the deduction for the \$13,600 finders fee paid by petitioner in 1975, and restored that amount as an income item and asset for said year. The basis of respondent's action was his determination that such expense was a part of the cost of the 1975 reinsurance transactions with Transport.

OPINION

The first issue is whether amounts paid by a reinsuring company to an initial insurer under a contract for indemnity reinsurance may be deducted currently or must be amortized over the anticipated useful life of the policies.

This Court addressed this question in Beneficial Life Insurance Co. v. Commissioner, 79 T.C. 627 (1982). In Beneficial, the taxpayer, a life insurance company, entered one assumption reinsurance transaction and seven indemnity reinsurance transactions. In each transaction, the taxpayer was the reinsuring company and received actual consideration from the initial insurer in an amount less than the reserve liability

actually assumed. This Court held that, with respect to both the assumption reinsurance transaction and the indemnity reinsurance transactions, the taxpayer must include in income an amount equal to the reserve liability actually assumed. We further held that, with respect to the assumption reinsurance transaction, to the extent the assumed reserve liability exceeded the actual consideration received, such excess represented the cost of business acquired which is amortizable over the useful life of that business. Beneficial Life Insurance Co. v. Commissioner, supra at 642-643. With respect to the indemnity reinsurance transactions, however, we held that to the extent the reserve liability assumed exceeded the actual consideration received, such excess represented a cost of issuing insurance which directly reduces the amount included in income. Beneficial Life Insurance Co. v. Commissioner, supra at 646. The Court stated that the Code itself requires different treatment of assumption reinsurance and indemnity reinsurance transactions with respect to the amounts the reinsuring company pays the initial insurer for the business acquired. The Court found that the Code treats an assumption reinsurance transaction as a sale by the initial insurer to the reinsuring company. Thus, the reinsuring company must amortize the cost of the business acquired over that business's useful life. Sec. 1.817-4(d)(2)(ii)(B), Income Tax Regs. An indemnity reinsurance transaction, however, is not treated as a sale by the initial insurer to the reinsurer, but as

the initial insurer's purchase of insurance from the reinsuring company. Reinsurance income includes the consideration received with respect to assuming another's contract liabilities, less "return premiums, and premiums and other consideration arising out of reinsurance ceded." Sec. 809(c)(1). "Return premiums" is defined in the regulations as follows:

(ii) The term "return premiums" means amounts returned or credited which are fixed by contract and do not depend on the experience of the company or the discretion of the management. Thus, such term includes amounts refunded due to policy cancellations or erroneously computed premiums. Furthermore, amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded shall be included in return premiums. * * *

Sec. 1.809-4(a)(1)(ii), Income Tax Regs. Thus, we held in Beneficial that the amount the reinsuring company returns to the initial insurer as a ceding commission may be deducted from the consideration received by the reinsuring company from the initial insurer. We have reviewed the analysis set forth in Beneficial and we find it directly applicable to the instant case. Accordingly, we hold that the amount of the ceding commission paid by petitioner to Transport may be deducted.

Respondent argues generally that the cost to petitioner of its reinsurance transactions constitutes an investment in the nature of a capital expenditure or a deferred expense, which must be amortized over the reasonably anticipated life of each respective transaction. In Beneficial we responded to a similar argument and therein distinguished the acquisition of an asset from the sale of insurance. We stated:

Although a reinsuring company does acquire an asset in a broad sense in the form of potential future profit, such is also true when an insurance company issues a single policy to an individual. Yet, the expenses relating to that policy are currently deductible. While respondent's argument is appealing, it does not comport with how life insurance companies are taxed with respect to insurance they issue. In essence, respondent argues indemnity reinsurance should be taxed as is assumption reinsurance; yet, the Code treats one as the issuance of insurance and one as acquisition of an asset. That makes all the difference.

Beneficial Life Insurance Co. v. Commissioner, supra at 647-648.

In support of his position that the amounts in question must be amortized respondent relies upon Southwestern Life Insurance Co. v. United States, 560 F.2d 627 (5th Cir. 1977), cert. denied 435 U.S. 995 (1978). In that case the taxpayer, in purchasing the stock of another insurer, paid an amount in excess of the value of the assets of the acquired company. The Court of Appeals sustained respondent's denial of a current deduction of that excess and found that the taxpayer should amortize that amount based on section 1.817-4(d)(2), Income Tax Regs. That section requires the reinsurer in an assumption reinsurance transaction to treat any amount paid to the reinsured for the purchase of such contracts, to the extent such amount meets the requirements of section 162, as a deferred expense under section 809(d)(12) and amortize such amount over the reasonably estimated life of the contracts reinsured, irrespective of the taxable year in which such amount was paid to the reinsured. According to respondent, because indemnity reinsurance is, by definition, of limited duration, there is no question but that the reinsuring

company in an indemnity reinsurance transaction is entitled to amortize its costs over the useful life of the policies reinsured. He concludes that the above regulation was intended merely to assure equal treatment in assumption reinsurance transactions by clarifying the period of amortization, thereby rebutting anticipated claims that the reinsured policies have an indeterminate life and costs connected with their acquisition are, therefore, not amortizable. Furthermore, respondent contends that the above regulation was intended to establish conclusively the right of the reinsuring company in an assumption reinsurance transaction to amortize its costs, not to authorize by inference the current deduction of the ceding commission in indemnity reinsurance.

We disagree with respondent's initial assertion for the reasons set forth in support of our holding in Beneficial. Further, a determination as to whether the purpose of the above regulation is to assure the reinsuring company in an assumption reinsurance transaction of a right to amortization is irrelevant to our determination of the issue in this case because the transactions here in issue are indemnity reinsurance transactions, not assumption reinsurance transactions. Finally, petitioner herein does not assert entitlement to a deduction for the ceding commission paid to the initial insurer based on an inference drawn from the above regulation, but rather on the express language of section 809(c)(1).

Respondent next contends that section 809(c)(1) was misconstrued in Beneficial. He first argues that the "premiums and other consideration arising out of reinsurance ceded" to be subtracted from premium income are those paid by an initial insurer to a reinsuring company and, therefore, serve to reduce the premium income of the initial insurer and not that of the reinsuring company. Respondent compares the language of section 809(d)(7) with the language of section 809(c)(1). Section 809(d)(7) provides for the deduction of "consideration (other than consideration arising out of reinsurance ceded) in respect of the assumption by another person of liabilities under insurance and annuity contracts * * *." Respondent asserts that the phrase "consideration arising out of reinsurance ceded" appearing in that section must be construed in the same manner as the identical phrase found in section 809(c)(1). He maintains that section 809(d)(7) provides for a deduction by the initial insurer and concludes that section 809(c)(1) also must provide for a deduction by the initial insurer. Finally, he states that the reduction allowed by section 809(c)(1) is an allowance in the case of reinsurance ceded (indemnity reinsurance, see sec. 1.809-4(a)(1)(iii), Income Tax Regs.) analogous to the deduction allowed under section 809(d)(7) in the case of assumption reinsurance.

We disagree with respondent's reading of section 809(c)(1) for the following reasons. Although we believe respondent is correct in his assertion that section 809(d)(7) provides for a deduction by the initial insurer, we do not read section 809(c)(1) so narrowly. First, although the phrase "other consideration arising out of reinsurance ceded" is found in both section 809(d)(7) and section 809(c)(1), this phrase only specifies the sum being referred to, and does not indicate who would be entitled to the deduction with respect to that sum. To find otherwise would be to read this phrase out of context.

Second, by using the phrase "consideration in respect of assuming liabilities under contracts not issued by the taxpayer," the first clause of section 809(c)(1) refers specifically to a reinsuring company. It would therefore be illogical to construe the second clause as referring only to an initial insurer. The drafters of this section made clear their intent in the first clause; where no similar restriction is expressed in the second clause, none will be imputed.

Respondent next argues that petitioner cannot rely on the first clause of the second sentence of section 809(c)(1) as authority for its claimed deduction. That sentence states: "Except in the case of amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded, amounts returned where the amount is not fixed in the contract but depends on the experience of the company or

the discretion of the management shall not be included in return premiums." (Emphasis added.) For support, respondent turns to the legislative history of section 809(c)(1) and section 820. The first clause of the second sentence of section 809(c)(1) (emphasized above) was added to the bill that became the Life Insurance Company Income Tax Act of 1959 in connection with the addition of section 820. The purpose of the enactment of section 820 was to avoid double taxation with respect to modified coinsurance. The Senate Report discussing the provisions of this bill states that dividends to policyholders, paid with respect to the reinsured policy, are to be treated as dividends paid by the reinsurer rather than the initial insurer to the extent of reimbursement by the reinsurer to the initial insurer, while experience refunds paid by the reinsurer to the initial insurer are treated as reductions in premium income of the reinsurer and as other income received by the initial insurer thus avoiding double taxation. S. Rept. No. 291, 86th Cong., 1st Sess. (1959), 1959-2 C.B. 770, 798. Respondent correctly asserts that the first clause of the second sentence of section 809(c)(1) was enacted to prevent the treatment of experience refunds in the same manner as payment of dividends to policyholders by reinsurers. Respondent appears to argue, however, that because section 809(c)(1) was added to the Code contemporaneously with section 820, its application is limited to experience refunds. Because the amounts at issue in the instant case and in

Beneficial were not experience refunds, received by the reinsurer and returned to the initial insurer, respondent claims that such amounts are not within the purview of section 809(c)(1).

Return premiums are defined in the regulations as amounts returned or credited which are fixed by contract and do not depend on the experience of the company or the discretion of the management. Sec. 1.809-4(a)(1)(ii), Income Tax Regs. Respondent's argument apparently equates "return premium" with "experience refund" in construing the return requirement of section 809(c)(1). However, the statute and the regulations specifically exclude experience refunds from the definition of return premiums. See sec. 809(c)(1); sec. 1.809-4(a)(1)(ii), Income Tax Regs. The amounts at issue in the instant case, as in Beneficial, were fixed by contract and were not determined by or dependent on the company's experience. Therefore, respondent's assertion that the amount paid to the initial insurer is an experience refund is incorrect. Further, although the reinsurer received only the excess of the required reserves over the initial consideration contained in the contract, respondent agrees that the full amount of the reserves was constructively realized by the reinsurer and is includable in gross income. Respondent, however, refuses to accept that the reinsurer constructively returned an amount (the ceding commission),

specified in the contract, to the initial insurer. Under Beneficial, petitioner may reduce the gross amount received from Transport by the amount constructively returned to Transport.⁴

Finally, respondent conceded on brief that resolution of the principal issue herein would be determinative of the treatment to be accorded the finders fee of \$13,600. Thus, petitioner is allowed a deduction for such amount in the year in which it was paid.

To reflect concessions of the parties and the foregoing,

Decision will be entered
under Rule 155.

⁴ We recently reached the same conclusion on similar facts in Individual Life Assurance Co. v. Commissioner, T.C. Memo. 1986-201, and Modern Security Life Insurance Co. v. Commissioner, T.C. Memo. 1985-629.

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T. C. Memo. 1986-227

UNITED STATES TAX COURT

CHARLES G. GOLDSMITH, Petitioner v. COMMISSIONER OF
INTERNAL REVENUE, Respondent

Docket No. 20787-83.

Filed June 5, 1986.

Held: Petitioner did not own more than 50 percent in value of the stock of a foreign corporation and, therefore, was not taxable on its income under section 551 et seq. Held further, petitioner did not divert to his own account \$178,000 of income of a corporation of which he was chief executive officer.

William A. Carey, for the petitioner.

Sharon C. Armuelles, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

WHITAKER, Judge: Respondent determined deficiencies in petitioner's Federal income taxes for the calendar years 1975 and 1977 in the amounts of \$1,052,741 and \$86,544, respectively. All issues for the year 1977 having been settled between the parties, we must determine whether or not petitioner is taxable for the year 1975 on \$1,384,407 of foreign personal holding company income and whether petitioner omitted an additional \$178,000 of taxable income from his 1975 Federal income tax return.

Explanation of Issues

The issues in this case arose during petitioner's tenure as Chief Executive Officer (CEO) of Intercontinental Diversified Corp. (ICD), a Panamanian corporation formed in 1970. More precisely, it is respondent's contention that Zodiac Shareholdings, Inc. (Zodiac), also a Panamanian corporation and the successor by change of name to Groves Development Co. Inc. (Development Co.) was, during the year 1975, wholly owned by petitioner individually and for his own benefit, making it a foreign personal holding company under section 552.¹ Respondent further contends that in 1975 petitioner caused ICD to purchase from Zodiac shares of The Grand Bahama Development Company, Limited (Devco), a Bahamian corporation, for a grossly inflated price. The alleged gain on this transaction is the principal element of the foreign personal holding company income. The

¹ All section references are to the Internal Revenue Code of 1954, as amended and in effect during the year in issue.

omitted income of \$178,000 is comprised of three items: \$94,000 transferred from ICD to Castle Bank & Trust Limited (Castle), a bank based in Nassau, Bahamas; \$75,000, also transferred from ICD to Castle and thereafter to Zodiac; and, \$9,000 of ICD funds transferred to petitioner.

FINDINGS OF FACT

Some of the facts have been stipulated and they are so found. At the time the petition in this case was filed, petitioner was a resident of Palm Beach, Florida.

Background Information

In 1955, Wallace Groves (Groves) caused The Grand Bahama Port Authority, Limited (Port), a Bahamian corporation, to be organized to construct a deep water harbor and to develop land primarily for industrial purposes, in the area of Freeport on Grand Bahama Island pursuant to an agreement with the Bahamian Government, authorized by an Act of the Governor, the Legislative Counsel, and the Assembly of the Bahama Islands. Fifty percent of the stock of Port was owned indirectly by Groves' wife,² 25 percent by Sir Charles Hayward (Sir Charles) of London, England, and the remainder by a group of investors. Groves was CEO and Sir Charles was Chairman of the Board of Port. Petitioner, during the period 1958 through 1968, was a director of Port and President of a subsidiary of Port. Devco was organized in 1961 as a 50-percent owned subsidiary of Port to

² Although Mrs. Groves was an inactive participant in business affairs, it apparently was Groves' custom to cause her to hold title to securities. We conclude that, from a practical standpoint, beneficial ownership was in the Groves' family unit.

promote residential development in the Freeport area. In 1968 92.5 percent of the outstanding stock of Port was acquired by Benquet Consolidated, Inc. (Benquet), a Philippine corporation, in exchange for shares of Benquet stock. The remaining 7.5 percent was owned by the Bahamian Government. Groves continued as CEO of Port.

Conflict developed between Groves and the Hayward family, including Jack A. Hayward (Hayward), the son of Sir Charles. As a result of irregularities committed by Groves in 1970, he was forced to resign as CEO and Director of Port, but he installed in his place a management team selected by him. Again controversy developed between the Hayward interests and Groves. Edward St. George (St. George), an English barrister and formerly Chief Magistrate and thereafter Solicitor General of the Bahamas, was the legal advisor to the Hayward family and was involved in their running battle with Groves. When the new management was ousted, St. George was instrumental in selecting petitioner as the compromise CEO for ICD, effective in January 1972.³

In the meantime, a plan of reorganization of Benquet had been developed pursuant to which all of its assets located outside of the Philippines, principally the common stock of Port, were to be transferred to ICD with the shares of ICD then to be exchanged share-for-share for shares of Benquet so that such of the shareholders of Benquet as wished to do so could become

³ We assume that petitioner actually took office as CEO of Port which apparently continued to run the business until ICD became operational in 1974.

shareholders of ICD rather than Benquet. In effect this resulted in creation of two publicly held corporations, one holding Philippine assets and the other non-Philippine assets. The purpose of the reorganization was to allow shares of Benquet and ICD to be exchanged so that 60 percent or more of Benquet's share ownership would end up in the hands of Philippine citizens. It was expected that the Groves-Hayward interests would own the controlling interest in ICD. This plan was consummated in 1974 at which time ICD became operational. Groves, through Mrs. Groves, became the largest shareholder of ICD with approximately 34 percent of its outstanding stock. Sir Charles was the second largest shareholder.

A significant factor contributing to the continuing and bitter controversy between Groves and the Hayward family (and their counselor St. George) was the predilection of Groves to run Port and its subsidiaries autocratically. As the controlling shareholder he apparently felt little responsibility to Sir Charles, the largest minority shareholder. The acquisition by Benquet appears to have had little impact on Groves' control and management of Port. However, the Haywards and St. George expected that petitioner would serve the interests of all shareholders and would in effect exclude Groves from any substantial influence on future management of ICD. This did not, in fact, happen, but acting in reliance on their understandings with petitioner the Haywards and St. George paid little attention to the operations of ICD from 1972 until late in 1975.

1972 through 1975

During the period 1972 through 1975, from the standpoint of the Hayward interest, petitioner had the authority to and was in fact expected to be managing ICD in his discretion. However, Groves continued to occupy the CEO's suite in what had been Port's office and became the ICD headquarters. Petitioner occupied the office adjacent to the CEO suite, allocated to the President of ICD. Contrary to his understanding with St. George and the Haywards, petitioner consulted constantly with Groves and especially during the first part of this period, left much of management to the remaining officers, spending much time in New York City attending to his other business activities. Consequently the other officers were free to consult frequently with Groves. During this entire period, no major business action was carried out by ICD without Groves' knowledge and approval (implicit or explicit).

A constant business consideration at this time was the need to maintain friendly relations with the then government of the Bahamas, the Progressive Liberal Party (PLP), as well as the minority Free National Movement Party (FNM). The latter had been in control of the Government and, at least in 1972 and 1973, was actively trying to return to control. Contributions to political parties are legal in the Bahamas⁴ and ICD and its predecessors

⁴ Although the making of political contributions by ICD in the Bahamas plays a major role in this case, neither petitioner nor respondent has supplied us with acceptable evidence that such contributions were, during the period involved, legal under Bahamian law. There are also at least inferences in the record (footnote continued)

for many years made a practice of contributing to the FNM Party, both while it was the governing party and after its ouster by the PLP. Petitioner was aware of the ICD's policy of making political contributions and was also aware that the amount of such contributions and the person or party to which made needed to be kept confidential. This was difficult since a representative of the Government was a director of ICD. Petitioner considered that he was "the point man" for political activity in the Bahamas on behalf of ICD and its subsidiaries, an important activity in view of the election anticipated during 1973. Accordingly, petitioner in consultation with Groves concluded that a slush fund should be set up in an off-the-books bank account to be used for political contributions.

At some point, although whether before or after 1972 is unclear, a procedure had been initiated by Port or ICD and the subsidiaries for securing cash for political contribution purposes without reflecting that use on ICD's books. The procedure involved having suppliers submit false invoices for services. On payment of the invoices the suppliers would remit the funds back to ICD or as it directed. This procedure appears to have been suggested by Miami, Florida counsel for ICD, a former member of which, Mary Jane Melrose, was serving as Vice

(footnote continued from previous page)
that contributions to individual politicians as distinguished from those to political parties were, at best, somewhat delicate if not illegal. However, everyone involved in this case, the parties and the nonparty witnesses, have operated on the assumption that contributions to political parties in the Bahamas were legal and we accordingly accept that as a correct characterization of Bahamian law.

President, General Counsel, and Director of ICD. The officers of ICD, including Donald C. de la Rue, Vice President-Finance and, of course, petitioner, were involved in this procedure, which was also known to Groves, Hayward, and St. George. Among others, St. George and his Freeport office assisted by submitting false invoices as did other respected Bahamian counsel. Since there was no income tax in the Bahamas, this practice did not affect adversely obligations owed to the Bahamian Government and appears to have been viewed as both legal and ethical.⁵

In addition to this practice, from time to time ICD cash was physically transported from the United States to the Bahamas without reporting the facts to the appropriate agency of the United States in violation of U.S. currency laws. At least some of this cash was delivered to petitioner.

Groves, with the assistance of Thomas Rozak,⁶ made available to petitioner an inactive Pamanamian company, Development Co., as the vehicle for the holding of ICD funds in an off-the-books bank account. The officers and Board of Directors of Development Co. were Groves, Mrs. Groves, and Rozak. The stock of Development Co. was in the form of "bearer" shares, possession of which

⁵ It is not our function to judge the propriety of this practice or its legality under United States standards, not withstanding the fact that ICD was listed on the New York Stock Exchange. As such, it was required to file reports with the Securities and Exchange Commission (SEC), many of which may have been false or misleading because the fact of the making of political contributions was not revealed.

⁶ Rozak acted as Groves' personal assistant for many years. He also served during this period as director and secretary of ICD.

reflected ownership. According to the minutes of Development Co., Mrs. Groves was the possessor of the bearer shares which reflected Groves' practice and was consistent with the holding of stockholder and director meetings at the Groves' residence. In any event, the shares were subject to the control of Groves. Development Co. maintained its bank account in the Royal Bank of Canada in Montreal (Royal Bank), the same bank in which ICD maintained its principal bank account. Until the early part of 1975, the sole signatories on the bank account were the two Groves and Rozak. Groves had requested that Development Co.'s name be changed and, effective on August 21, 1973, the name became Zodiac Shareholdings, Inc. (Zodiac). In April 1975, Rozak resigned as Director and Secretary/Treasurer of Zodiac and Peter Aston, an individual then acting as bookkeeper for petitioner, was appointed Director and Secretary/Treasurer and also became a signatory on the bank account. Petitioner never had signature authority over any bank account of Development Co. or its successor Zodiac. At least through April 15, 1975, Mrs. Groves continued as the holder and therefore the legal owner of the bearer shares. There is no evidence of the holding of shareholder or director meetings subsequent to April 15, 1975.⁷

At a point in time unknown an effort was made to reissue the Development Co. bearer shares in Zodiac's name. The certificate appears to have been filled out but it was not signed by the

⁷ Counsel have not undertaken to discuss on brief the effect of the lack of further meetings. Presumably that did not alter the authority of the officers and directors to continue to act for and in Zodiac's name.

officers--Groves or Mrs. Groves and Rozak or Aston--at least until after petitioner's resignation as CEO of ICD in February 1976. There is no evidence as to the ultimate disposition of the Development Co. share certificates held by Mrs. Groves. During the period April 15, 1975, until after petitioner's resignation, the physical location of the Development Co. certificates is unclear.⁸

In early 1972, ICD initiated a program to purchase the minority interests outstanding in Devco. This program continued until all of the shares not owned by ICD, including those of petitioner, had been acquired. In May 1973, with the knowledge and approval of Groves, petitioner made a written offer to Development Co. to sell it petitioner's shares of Devco stock for an aggregate price of \$650,000 or \$3.25 per share. The terms of the offer called for an installment sale with the initial payment of \$125,000 being due immediately and the balance to be paid in

⁸ St. George testified consistently before us and in his SEC interrogation that he did not receive share certificates for Zodiac shares in February 1976 when he received other Zodiac corporate papers. Before us he explained that the problem was with counsel in Panama in connection with the corporate name change. Before the SEC he stated that the Development Co. certificate "had been handed back for reissue." Presumably action for reissuance of the certificate or certificates in the name of Zodiac should have been commenced in 1973 or shortly thereafter in connection with the name change handled by Rozak. Resolution of this fact issue would have been helpful but it is not critical to the case. We also note that neither party has seen fit to brief the question of ownership of a Panamanian corporation with bearer shares where the share certificate is in process of being reissued. Neither are we advised whether this corporation could then issue only bearer shares or whether that status depends on a legend on the certificate or otherwise. Thus, it is unclear whether after the effective date of the name change, Zodiac in fact had only bearer shares outstanding.

five equal yearly installments of \$105,000 each with interest. It was at the time intended both by petitioner and by Groves that ICD would ultimately become the owner of petitioner's Devco stock and ICD funds were used to pay the purchase price. A Nassau attorney, Geoffrey Johnstone, was designated as escrow agent to hold the shares of Devco stock pending payment in full of purchase price. The first installment was paid on May 23, 1973, with a check payable to petitioner drawn by Development Co. on its Royal Bank account. This check was signed by Groves and Rozak. Funds for this purpose were derived from \$117,000 paid by ICD to Johnstone and deposited to the Development Co.'s bank account at petitioner's direction. The sum of \$33,000 was also deposited in that bank account. On ICD's books the \$117,000 was recorded as an expenditure for the purchase of Devco stock. Another deposit was made in August 1973 to the Development Co. account by Johnstone using ICD funds. Petitioner reported gain on the installment sale of his Devco stock on his 1973 Federal income tax return.

During this 1972-1976 period, using the false invoice procedure, substantial ICD funds were transferred to the Development Co.-Zodiac bank account. Funds so deposited were, by and large, invested and reinvested in certificates of deposit issued by the Royal Bank to the extent not expended. Similarly, funds were transferred to Castle in this indirect route.⁹ In

⁹ During a portion of this period, another Groves Panamanian corporation, Atlanta Bahamas Company, also with a bank account in the Royal Bank, was used as a depository for certain ICD funds, (footnote continued)

June 1974, Zodiac issued its check, signed by Rozak, in the amount of \$575,875 to petitioner representing the balance due on the installment sale of Devco stock plus accrued interest.

The use of fictitious invoices to generate political contribution funds on an ad hoc basis was found to be a cumbersome method. It also required that the monies disbursed be treated as expenses for financial accounting purposes. It was recognized that if funds could be generated through the purchase of an investment asset the expenditure would be recorded in ICD's investment account, thus having no adverse affect on net earnings. By September 1975, the only outstanding Devco stock not owned by ICD was the block of shares formerly owned by petitioner which had been paid for by Development Co.-Zodiac using ICD funds but which may still have been held in the name of Johnstone as nominee. Petitioner, with Groves knowledge and approval,¹⁰ caused ICD to purchase this stock for \$10 a share, far in excess of the average per share cost of the minority shares acquired by ICD and, of course, substantially in excess of the \$650,000 paid to petitioner for his stock. Two million dollars in ICD funds was channeled through Johnstone to Zodiac in

(footnote continued from previous page)
which ultimately were transferred to Zodiac. These facts are significant only insofar as they reflect Rozak's participation in Zodiac long after, according to his testimony, he ceased to have any knowledge of Zodiac's activities.

¹⁰ We are constrained to conclude that Rozak was fully aware of transactions such as this in spite of his denials during his SEC interrogation. We are also impressed with St. George's testimony that Johnstone would not have participated in the diversion of large amounts of ICD funds to Zodiac without the knowledge that Groves concurred in the plan.

payment of the purchase price, reflecting an apparent book profit to Zodiac of \$1,350,000. Payment to Zodiac was handled by de la Rue. It is this book profit, together with some \$35,000 of interest earned by Zodiac, which respondent has determined to be foreign personal holding company income taxable to petitioner in the year 1975. By the end of 1975, Zodiac had on hand almost \$3,000,000.¹¹

January - February 1976

St. George returned to the Bahamas in December 1975 for personal reasons. Various bits and pieces of information which came to him somewhat haphazardly made him suspicious that there may have been an improper diversion of ICD funds which ostensibly had been intended for political contributions. In a discussion with Johnstone, St. George became convinced that a large sum of money, which he estimated to approximate \$3,000,000, had been diverted by petitioner to Zodiac and accumulated instead of being immediately used for political contribution purposes and/or to acquire Devco stock. Hayward immediately came to Freeport at St. George's request to participate in the resolution of this problem. St. George discussed this matter both with

¹¹ Although there is no evidence on this point, we do not believe Groves would have permitted petitioner's Devco stock to be purchased by Development Co.-Zodiac with ICD funds without some logical reason. The obvious inference is that the plan to sell the stock to ICD, at an inflated price, was devised in 1973. Moreover, Groves certainly would not have permitted ICD to pay \$10 per share to Zodiac for petitioner's former stock unless he had had some control over the ultimate disbursement of the \$2,000,000.

Groves and with petitioner.¹² St. George and Hayward initially suspected that the funds in Zodiac represented another effort by Groves at misappropriation with the assistance of petitioner, but accepted Groves' disclaimer of knowledge of the diversion of ICD funds. When petitioner was confronted by St. George in early February, petitioner admitted that approximately \$3,000,000 of ICD funds had been deposited in the Zodiac bank account. Without permitting petitioner to make a full explanation, St. George insisted that all Zodiac documents should be turned over to him and the funds returned to ICD control. St. George represented to petitioner that, if St. George obtained the Zodiac books and records and Zodiac funds in the amount of \$3,000,000 and if petitioner resigned, he and Hayward would take no action against petitioner, although he was then convinced that petitioner had intended to misappropriate these ICD funds. By February 19, 1976, St. George's demands were met.

In the meantime, Groves undertook to persuade petitioner to document for Groves' benefit that Groves had had no knowledge of the transfer of ICD funds into Zodiac account and that Zodiac had been owned and controlled by petitioner since 1973. Accordingly, several documents were prepared and exchanged between petitioner and Groves during February 1976 (the February Documents), several of which were back dated to 1973. Rozak was an active participant in his capacity as Groves' assistant in the drafting and exchange of these Groves-petitioner documents. Discussing

¹² It is unclear whether the matter was first discussed with Groves or petitioner, but that discrepancy is immaterial.

them in the order of their purported dates, a note handwritten by petitioner and dated April 1, 1973, was given to Groves. In this note petitioner purported to request that Mr. and Mrs. Groves transfer to him the shares, sharebook, and corporate papers of Development Co. Petitioner acknowledged in the note that the name "Groves" would be eliminated from the corporate name and that the resignations of both Groves and Rozak as officers and directors would be acknowledged and accepted.¹³ The language of the note was prepared by Groves and/or Rozak and presented to petitioner by one or the other of those individuals.

The next of the backdated February Documents dated May 15, 1973 purports to reflect an agreement between Mrs. Groves and petitioner "as agent" for the sale by Mrs. Groves of the Development Co. stock with an acknowledgment of the transfer to petitioner of the share certificate, the corporate seal, and corporate records. Petitioner's signature purports to have been witnessed by Groves. A document dated February 18, 1976, and apparently delivered to petitioner on or about that date, from the two Groves make formal demand for acceptance of their resignations as officers and directors of Zodiac. This document

¹³ The copy of the handwritten note received in evidence is totally illegible. A typed document identical with the handwritten note except that the typed document shows as a signature the word "Gerry" before which appears the symbol "/s/" implying that this typed document is a copy of the handwritten note was also received as a stipulated exhibit. We accept petitioner's testimony that the typed version was presented to him with a request that he copy it in long hand, which he did. The critical fact is that the document was prepared at Groves' request and back dated in an effort to get Groves "off the hook" with the St. George-Hayward faction.

purports to recite that the alleged acquisition of the stock of Development Co. by petitioner took place in March or April 1973. The document also reflects the fact, which Groves could not deny, that Groves participated in the installment sale of petitioner's Devco stock to Development Co. Petitioner made one handwritten change in the text reflecting his insistence in February 1976 that ownership of the Zodiac stock was acquired in a fiduciary capacity as an agent for an undisclosed principal. Petitioner also endorsed on the document a statement that there were "other transactions in the company" but that the facts that were recited were correct. These February Documents are simply incorrect to the extent that they purport to reflect an actual purchase in 1973 by petitioner for his own account of the Development Co. stock and a delivery to petitioner of the share certificates. Creation of these documents was instigated by Groves in his effort to stave off further controversy with the Hayward interests and St. George. Petitioner acceded to Groves' insistence since it did not appear to make any difference to him and might leave less controversy between the ICD shareholder groups. We are satisfied that in February 1976, no one anticipated that a \$1 million tax liability would be asserted against petitioner based largely on these February Documents.

On February 19, 1976, at the conclusion of the February confrontations, St. George did receive the Zodiac corporate file,¹⁴ but as we have found no share certificate had been issued in the name of Zodiac. We are also satisfied that the share certificates in the name of Development Co. were not with the Zodiac papers or otherwise delivered to St. George. It is thus unlikely that the Development Co. certificates were among the corporate papers in the ICD headquarters. In any event bearer share certificates for the Development Co.-Zodiac corporation were never in petitioner's personal custody. If such shares were in fact at any time after petitioner became CEO constructively in petitioner's possession, it would have been in his capacity as CEO of ICD and for the benefit of ICD.

On February 19, 1976, petitioner executed two affidavits, one of which purports to exonerate the Groves and Rozak from any knowledge or responsibility for Zodiac and releases each of them from any liability. The second recites that an aggregate of \$3,000,000 has been held in suspense and is in the account of Zodiac and that petitioner delivered all of the issued and outstanding shares of Zodiac to St. George and to de la Rue. Although the source and purpose of these two affidavits is not entirely clear, both are acknowledged by an attorney formerly in the law office of St. George in Freeport. They appear to be based, at best, on an incorrect understanding of the facts and on

¹⁴ St. George testified that Rozak left the February 19, 1976, meeting, and returned with the Zodiac corporate file which he delivered to petitioner. Petitioner then delivered the file to St. George.

some generalized concerns of counsel. To the extent that these affidavits are inconsistent with the facts we have found, they, like the other items comprising the February Documents, must be ignored.

Petitioner at the request of St. George, telephoned the Royal Bank to request a transfer of the funds in the Zodiac account to a special account set up by St. George for this purpose. The Royal Bank refused to act, however, until that request was confirmed in writing by an individual authorized to withdraw funds from the account. Either Rozak or Aston handled this function. The funds in the Zodiac account, amounting to slightly less than \$3,000,000, were transferred to ICD's control. Thereafter, ICD accepted the transfer of petitioner's lease on the apartment in Freeport used as his residence to make up the deficit in the bank account so that ICD would recover the \$3,000,000 demanded by St. George.

Subsequent Events

At some point, presumably in 1974 when ICD became operational, its stock was listed on the New York Stock Exchange as a publicly-held company. As such it was subject to the rules and regulations of the SEC. At no point prior to February 1976 did the periodic filings with the SEC reflect the payment of political contributions, the use of false invoices to accumulate funds, and the build up of a slush fund in the Zodiac account. On the advice of counsel, ICD reported to the SEC in 1976 or 1977 facts with respect to the accumulation of the slush fund in the

Zodiac account, petitioner's participation therein, his termination as CEO, and the making of political contributions. An investigation was commenced by the SEC of questionable payments and other matters which ultimately led to court orders in 1978 enjoining ICD and petitioner from violating the law in the future. SEC employees were authorized to take testimony and a number of interrogations¹⁵ took place in the United States and in the Bahamas. Many documents were examined by the SEC employees. However, no published report of the investigation was made or filed. On advice of his counsel, petitioner declined to cooperate with or be interrogated by the SEC examiner. In connection with termination of the SEC investigation, ICD created an audit committee (Audit Committee) which continued to investigate facts and trace funds in order to ascertain, among other items, whether or not any monies were actually misappropriated by petitioner and whether any bribes had been paid to petitioner. Petitioner refused to be interviewed by Roger C. Minahan, a United States attorney, who had assisted St. George in February 1976 and was appointed as Chairman of the Audit Committee.

¹⁵ We have used the word "interrogation" for lack of a better description. Witnesses were sworn and were allowed to have counsel present but little or no interrogation was permitted by such counsel and none by other parties or their counsel. The proceeding was essentially one for fact finding but in several instances the SEC examiner urged witnesses to speculate, repeat hearsay, etc.

In addition, a stockholder's derivative action was filed on behalf of ICD and its shareholders in the name of Chris Pappas in the United States District Court for the Southern District of New York (77 CIV 6165 (RD)). A number of depositions were taken during the course of that law suit, but again petitioner declined to be deposed. That lawsuit ultimately was settled by payment of fees for the attorneys for Mr. Pappas, apparently following the purchase by the Haywards and St. George of sufficient shares of outstanding ICD stock for the company to be delisted by the New York Stock Exchange as a publicly-held corporation. The details of this suit are sketchy in this record and are immaterial to the issues before us except as they impact upon the numerous documents sought to be introduced into the record by respondent over the hearsay and other objections of petitioner, which objections were disposed of in 86 T.C. No. ___, (1986). Suffice it to say that no definitive findings of fact were made by the SEC, the Audit Committee, or in the Pappas proceeding.

\$178,000 Unreported Income

In the statutory notice respondent determined that petitioner received, in 1975, \$119,000 from Devco and \$59,000 from Freeport Commercial and Industrial Limited (FC&I), another subsidiary of Port, which monies petitioner failed to include in income. The \$119,000 item from Devco is composed of \$44,000 paid to St. George on May 30, 1975, in settlement of a fictitious invoice of like amount from Devco. By check dated June 3, 1975, St. George's office paid Castle \$44,000, the funds being received

by Castle on June 13, 1975. In addition, \$75,000 was paid by ICD to Johnstone by check dated March 21, 1975. This sum was, thereafter, transferred by Johnstone to Castle by check. Ultimately, the \$75,000 with other funds was transferred by Castle to Zodiac. The \$59,000 is composed of \$50,000 paid to St. George by FC&I by check dated May 16, 1975, which funds were thereafter transferred by St. Georges' office to Castle by check on June 3, 1975. An additional \$17,000 was paid to St. George by FC&I by check dated May 2, 1975. Of this sum \$8,000 was paid by St. George in settlement of an unrelated claim and \$9,000 was paid to petitioner in a form of a check payable to cash dated May 14, 1975. Petitioner used this \$9,000 to pay expenses of ICD, incurred to acquire shares of Devco in small lots from unrelated shareholders. A portion of these funds deposited with Castle was used for political contributions, for various unrelated transactions, and the balance was transferred by Castle to Zodiac's account in the Royal Bank. None of the \$178,000 which respondent determined was unreported income, was misappropriated by petitioner or used in any way for his personal benefit.

ULTIMATE FINDINGS OF FACT

Petitioner in his individual capacity never became the legal or beneficial owner or holder of the shares of Development Co.- Zodiac. During petitioner's tenure as CEO of Port and thereafter of ICD, petitioner did not misappropriate to his own use and benefit any funds of Port, ICD, or any of the subsidiaries of either corporation. To the extent that petitioner exercised

control over Zodiac and the funds deposited in and withdrawn from its Royal Bank bank account, petitioner was acting in his capacity as CEO of ICD and for the benefit of Port and, thereafter, ICD.

OPINION

Credibility of Witnesses

This is essentially a fact case and our findings of fact foretell the result. However, the parties, and especially respondent, are entitled an understanding of the basis for our factual conclusions. Petitioner's case rests almost entirely upon the credibility of his witnesses, i.e., petitioner himself and St. George. Respondent's case, on the other hand, depends largely upon the February Documents and upon hearsay statements to SEC investigators, to members of the Audit Committee and in depositions taken in the Pappas litigation, most of which we have excluded from evidence, in large measure, because of our conclusions as to their unreliability. Respondent also urges us to take note of the apparent violations of United States laws such as the failures to make required disclosures in SEC filings, especially as to the accumulation of the slush fund in Zodiac and the payments of political contributions as well as probable violations of certain U.S. currency laws to which petitioner was a party. To the extent that petitioner was not currently aware that such violations were occurring, he was at least indirectly responsible in his capacity as CEO and, hence, captain of the ICD ship. Respondent fails to realize, however, that business

standards in the Bahamas during the time period relevant to this case were not the same as in the post-Watergate era in the United States. Moreover, the disclosures during the post-Watergate era of similar malfeasance by executives of many United States corporations doing business abroad was not necessarily, or even frequently, accompanied by misappropriation of corporate funds by the executives concerned. Neither did the practice of paying foreign politicians for business necessarily imply that corporate executives were unreliable when testifying under oath.

Generalizations cannot be made. Further there is no particular significance in this case in the fact that petitioner may have directed ICD business to a personal friend.¹⁶ His participation in the use of false invoices in order to generate funds which could be used for political contributions in the Bahamas without disclosure of that purpose on ICD's books is similarly beside the point.

While by no means condoning the violations of United States laws and regulations by several of the executives of ICD, including petitioner, we do not consider these facts to have blackened the character of petitioner so as to make untrustworthy his testimony before us. During the trial we were fully aware of respondent's contentions and we have made our own judgments as to the credibility of the witnesses. We found petitioner to be sincere, forthright, and a thoroughly reliable witness. St.

¹⁶ Respondent contends that ICD funds were diverted to Angela Howard, a friend of petitioner. At various times she did work for Port or ICD or one of the subsidiaries for which she received payments.

George is an English barrister of note, who has served his country's Government in a number of important capacities. He voluntarily came to Florida to testify in this case at some personal inconvenience to himself. There can be no doubt either as to his veracity or his motives.¹⁷ Respondent characterizes the St. George SEC interrogation as more accurate than his testimony in this proceeding and it was, of course, closer in point of time to the critical events, particularly those in January and February 1976. However, we find the inconsistencies between his testimony before the SEC and before us fully explained. We also find convincing St. George's own judgment of himself. He testified:

I have no business interests, no business affiliations. My only reason for coming here is as I have said, that I think perhaps I judged him [petitioner] a little harshly initially, and I felt that I then had a moral duty to come and say what I really thought.

Finally, we have the fact that Groves knew about the purchase by Zodiac of petitioner's Devco stock with ICD funds and then its resale to ICD. As the owner of approximately 35 percent of the ICD stock, it is inconceivable that Groves would have permitted this accumulation of ICD funds in Zodiac if that company was, in fact, owned and controlled by petitioner individually. On the other hand, with Mrs. Groves as the sole shareholder and the Groves, Rozak, and Aston as the only persons authorized to withdraw funds from the Zodiac bank account, it is

¹⁷ Minahan is a thoroughly credible witness although his testimony contributes little to the resolution of this case.

fully understandable that Groves would have concurred in these (as well as other) transactions involving Zodiac. As to the ultimate motives of Groves, we need not speculate.

Comment is appropriate with respect to the procedure used by petitioner to accumulate the slush fund in Zodiac as it relates to respondent's view of his motivation. As we have found, many individuals associated with ICD knew petitioner was depositing large sums in Zodiac, including Groves, Rozak, Ms. Melrose, Johnstone, and probably Aston. D. C. de la Rue participated in the transfer of \$2,000,000 to Zodiac. While petitioner probably could have caused funds to be withdrawn and delivered to him for unsupervised use, that would have required the cooperation of Groves, Mrs. Groves, Rozak, or after April 1975, Aston. Such indirect control of Zodiac funds is hardly consistent with an intention on the part of petitioner, allegedly conceived in 1973, of using Zodiac to store funds misappropriated by him, unless all signators on Zodiac account were co-conspirators with petitioner.

Foreign Personal Holding Company Income Issue

The principal element in the 1975 deficiency in this case arises out of the treatment by respondent of Zodiac as a foreign personal holding company solely owned by petitioner. Insofar as relevant, sections 551 and 552 provide as follows:

SEC. 551(a) General Rule.--The undistributed foreign personal holding company income of a foreign personal holding company shall be included in the gross income of the citizens or residents of the United States, * * * who are shareholders in such foreign personal holding company * * * in the manner and to the extent set forth in this part.

SEC. 552(a) General Rule.--for purposes of this subtitle, the term "foreign personal holding company" means any foreign corporation if--

* * *

(2) Stock Ownership Requirement.--At any time during the taxable years more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals who are citizens or residents of the United States, hereinafter called "United States group".

The rules for determining foreign personal holding company income under section 551 are somewhat complex and have been substantially ignored by the parties in this case. The statutory notice treats the \$2,000,000 reported sale of Devco stock by Zodiac to ICD as a capital transaction, allowing Zodiac a basis equivalent to its cost, the sum of \$650,000 paid to petitioner. The gain of \$1,350,000 plus the interest income earned by Zodiac is determined to constitute foreign personal holding company income taxable to petitioner in his individual 1975 calendar year.¹⁸ The entire controversy with respect to the foreign personal holding company issue relates to whether or not petitioner was, in fact, the sole shareholder of Zodiac.¹⁹

¹⁸ There is no evidence as to the accounting year of Zodiac, the parties apparently assuming that it was the calendar year, so that its entire income for the year 1975 would be includible in petitioner's 1975 income.

¹⁹ Respondent on brief argues that Zodiac should have no basis in the Devco stock and therefore the gain on the sale of the stock in 1975 should be \$2,000,000 rather than \$1,350,000. Respondent's argument, made for the first time on brief, simply comes too late. Aero Rental v. Commissioner, 64 T.C. 331, 338 (1975). It is also immaterial.

In the determination of stock ownership for this purpose, we may look to the rules for determination of ownership in domestic personal holding companies under section 544. Section 1.552-3(a), Income Tax Regs. In Estate of Miller v. Commissioner, 43 T.C. 760, 766 (1965) we said "[w]e think there must actually be controlling U.S. shareholders of the foreign corporation before the foreign personal holding company statutes can have any effect." We must, therefore, determine whether or not petitioner was the controlling "U.S. shareholder." And in this context, the inquiry is whether or not petitioner was the controlling shareholder for his own account, and not as an agent or fiduciary for ICD.

It is appropriate to recall at this point that Development Co. was a Panamanian corporation, the shares of which are described as "bearer" shares. Although the significance of that terminology would, we presume, be in the first instance a matter of Panamanian and/or Bahamian corporate law, neither party has discussed the applicable law. Instead the parties seem to have accepted the fact that bearer shares are simply transferable by delivery and the holder of a certificate of bearer shares is presumed to be the owner. In this respect the bearer shares appear to be somewhat similar to shares of United States corporations issued in street names. See 11 Fletcher, Cyclopedia of the Law of Private Corporations, sec. 5091, p. 59 n. 18 (Perm. ed. 1978 rev.); 1 Christy, The Transfer of Stock, sec. 22, p. 3:1 and sec. 56, p. 7:15 (5th ed. 1975).

It is undisputed that Development Co. was organized at the instance of Groves in 1969 and that the bearer shares were held, and thus owned, by one or the other of the two Groves. We are satisfied that the copies of the corporate minutes which have been received in evidence are copies of the genuine minutes and that they correctly reflect in material respects the facts relevant to this case,²⁰ although with some obvious but unimportant errors. For example, at the May 31, 1973 meeting, the new name of the corporation is shown as Zodiac Shareholdings, Ltd., rather than Zodiac Shareholdings, Inc. The minutes of the Board meeting on the same day recite that Mrs. Groves contributed \$150,000 for additional stock whereas, in fact, the funds came from ICD. There are two copies of minutes of the annual meeting on February 17, 1975, both signed, which differ in that one set omits reference to certificate No. 2 for 900 shares.

Finally, the minutes of the last recorded shareholders' meeting held on April 15, 1975, uses the name Groves Development Co., Inc. rather than Zodiac Shareholdings, Inc. These inaccuracies reflect, we conclude, sloppy work on the part of

²⁰ Respondent objected to receipt in evidence of the minutes, because among other grounds, the corporate secretary Rozak is alleged to have stated that actual meetings as reflected in the minutes were not held but that the minutes were simply passed around for signature. Respondent's counsel apparently does not realize that that is a common practice among corporate secretaries and corporate lawyers in closely held United States corporations and the practice does not invalidate the corporate action reflected in the minutes or cast doubt on recitals therein as to stock ownership.

Rozak and his available secretarial staff. They do not serve to cast doubt on the basic representations contained in the minutes as to possession and ownership of the bearer shares.

Respondent argues, as to the copies of the minutes, that they are inadmissible and further that after May 1973 only "nominee" meetings were held as a convenience to petitioner. We simply do not believe that Rozak would have prepared minutes reflecting Mrs. Groves as the shareholder or that she and Groves would have approved and she would have signed minutes reflecting such fact, if, in fact, the shares had actually been transferred to petitioner. That the officers and directors might have continued to serve as a convenience to petitioner is at least possible; that Mrs. Groves would, for no reason, have allowed herself to be shown as the shareholder is beyond belief. The record fully supports our finding that through April 15, 1975, Mrs. Groves was treated as the holder of the bearer certificates.²¹ Whether between the two Groves, Mrs. Groves or Mr. Groves was the beneficial owner, we need not determine. We have also found that the Groves remained as Directors and the President and Vice President, respectively, through the date of

²¹ In the copy of the Listing Application to the New York Stock Exchange, Inc. filed by ICD, dated December 28, 1973 (Exhibit GH), Mrs. Groves is shown as sole shareholder of Groves Securities Co., Inc. which held the Port shares and then Benquet shares owned by the Groves. She is also shown as indirectly owning Devco shares, apparently the shares purchased by Zodiac from petitioner. While the minutes of Development Co.-Zodiac can be interpreted to reflect that Rozak may have had actual custody of the shares, his testimony in the Pappas litigation was very specific to the effect that Mrs. Groves personally brought the share certificate to the meetings. (See Exhibit 164, pp. 21-23).

petitioner's resignation as CEO of ICD. When Aston was substituted for Rozak as Corporate Secretary and Director on April 15, 1975, Mrs. Groves continued to be treated as the owner of the bearer shares. We are satisfied that the shares of the Development Co. stock were owned legally and beneficially by one or the other of the two Groves.

Although the name of the company had been changed on the public registry of Panama from Groves Development Company, Inc. to Zodiac Shareholdings Inc. effective August 21, 1973, up to the time of petitioner's resignation from ICD in February 1976, there was no outstanding share certificate issued in the name of Zodiac to anyone. However, we decline to believe that the ownership of Zodiac was in a vacuum by reason of the absence of a certificate in its name evidencing its shares. In the absence of evidence as to Panamanian or Bahamian corporate law to the contrary, we have to be guided by general principles of corporate law. We thus assume that the certificates No. 1 for 100 shares and 2 for 900 shares of Development Co. stock remained outstanding and continued to evidence the ownership of such numbers of shares (bearer or otherwise) in Zodiac.

Ignoring the fact recitals in the February Documents as to possession, as we have concluded we should, we are left with no evidence as to the actual whereabouts of the bearer shares subsequent to the April 15, 1975 joint shareholder-directors meeting of Zodiac. Rozak in his Pappas deposition did his best to convey the impression that when he delivered the Development

Co.-Zodiac corporate documents to petitioner (if in fact he did so), the bearer shares were contained therein. However, he was forced to state that he then (in July 1978) had no recollection of actually seeing the bearer shares in petitioner's position. That, of course, is consistent with the fact that Mrs. Groves had theretofore retained physical custody of them, as the minutes recite, all of which confirms petitioner's testimony that petitioner never received the share certificates. We conclude that petitioner never had personal custody of the Development Co.-Zodiac bearer certificates.²²

We are further convinced that petitioner's only contact with Development Co. or Zodiac was in his capacity as CEO of ICD. Petitioner did effectively control the Zodiac bank account in the Royal Bank in the sense that as CEO of ICD he was able to cause funds to be deposited in and withdrawn from it. And this bank account appears to be the only business activity Zodiac carried on during this period. That brings us to the legal question of whether or not the connection which petitioner admittedly had with Zodiac as CEO, but without either personal possession or control of the bearer share certificates, is sufficient to cause him to be characterized in his individual capacity as the sole member of the "United States group" of shareholders.

²² If petitioner had possession of the Atlantic Bahamas bearer's certificate, it was constructively and for the benefit of ICD on the assumption that the Atlantic Bahamas corporate papers were delivered by Rozak to Aston as successor Corporate Secretary for Zodiac. See n. 9.

Turning to section 544, stock owned directly or indirectly by or for a corporation is treated as being owned proportionately by its shareholders. If the Development Co.-Zodiac bearer shares were in fact being held by Groves or Mrs. Groves for the benefit of ICD, as we believe, or even by petitioner as CEO of ICD, petitioner as a minority shareholder of ICD, would be treated as a minority shareholder of Zodiac. Respondent does not and on the facts cannot argue that the 50-percent test is so met or that in this fashion 100 percent of Zodiac's 1975 income is taxable to petitioner.

Were we to construe the facts, including inferences from inadmissible documents, most favorably to respondent, we can do no more than find that petitioner controlled Zodiac for the benefit of ICD. The funds in the Zodiac bank account were at all times intended to be used for ICD's benefit. Zodiac had no claim to such funds and the paper gain which respondent seeks to treat as income to petitioner arose out of a simulated transaction. Zodiac's only income in 1975 was its \$35,000 interest income which also belonged to ICD since the invested funds belonged to ICD. The paper gain of \$1,350,000 was ICD's not Zodiac's. But even if on some theory petitioner were estopped to deny that Zodiac realized this gain, it still would not be taxable to petitioner.

With the February Documents entitled to little credence, petitioner's credible testimony corroborated by St. George, by documents and by logical inferences, and nothing to the contrary except inadmissible, unreliable hearsay, we hold for petitioner on the foreign personal holding company issue.

\$178,000 Unreported Income Issue

Our fact findings are again sufficient to dispose of this issue. Petitioner did not use or appropriate for personal purposes any element of this sum of money. Therefore, we find for petitioner on this issue.

By reason of the stipulated deficiency for the year 1977,

An appropriate order will
be entered.

COMPLETED

JU 11.7/2: 1986-228

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T. C. Memo. 1986-228

UNITED STATES TAX COURT

JOHN W. BURGESS AND LINDA M. BURGESS, Petitioners v. COMMISSIONER
OF INTERNAL REVENUE, Respondent

Docket Nos. 26484-82, 21629-83. Filed June 5, 1986.

Richard A. Jessup and Marc H. Cochran, for the petitioners.*

Robert E. Casey and Michael R. McMahon, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

WILBUR, Judge: Respondent determined deficiencies in petitioners' Federal income tax for the taxable years 1978, 1979, and 1980 in the following amounts:

*

Brief amicus curiae was filed by Kenneth O. Eikenberry as Attorney General for the state of Washington.

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<u>Year</u>	<u>Deficiency</u>
1978	\$2,341
1979	2,922
1980	4,026

The issues for decision are:

(1) Whether the Washington Law Enforcement Officers' and Fire Fighters' Retirement System (Title 41, Chapter 41.26 of the Wash. Rev. Code Ann. (1974 Supp.)) is "in the nature of a workmen's compensation statute" for the purposes of section 104(a)(1)¹; and, if so

(2) Whether petitioner John W. Burgess' disability arose from participation in activities carried out in the line of duty.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly. The stipulation of facts and attached exhibits are incorporated by this reference.

Petitioners John W. Burgess (petitioner or Burgess) and Linda M. Burgess were husband and wife, residing in Sumner, Washington, when they filed the petitions in this case. Their joint Federal income tax returns for the calendar years 1978, 1979, and 1980 were timely filed with the Internal Revenue Service, Ogden, Utah.

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Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the taxable years in issue.

Burgess served as a probationary "fire fighter"² with the city of Auburn in conjunction with the Public Employment Program (PEP)³ which supplied partial funding for petitioners' position. To be hired and paid exclusively by the city of Auburn as a fire fighter, petitioner had to pass the Civil Service Examination. While a probationary fire fighter, Burgess did take the Civil Service Examination but failed to pass the agility portion of the exam.

The fire chief for the city of Auburn suggested that petitioner pursue some plan to build up strength in his arms in order to pass the agility test and become a better fireman. PEP allocated the funds to pay for petitioner's enrollment in a physical conditioning class. On November 15, 1973, petitioner

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Wash. Rev. Code Ann. sec. 41.26.030(4) (Supp. 1974) states:

(4) "Fire fighter" means:

(a) any person who is serving on a full time, fully compensated basis as a member of a fire department of an employer and who is serving in a position which requires passing a civil service examination for fire fighter, or fireman if this title is used by the department, and who is actively employed as such; [Emphasis added.]

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The Public Employment (PEP) was authorized by the Emergency Employment Act of 1971, Pub. L. 92-54, 85 Stat. 146, 42 USC sec. 4871 (1970). Petitioner's position with the city of Auburn extended from January 1972 to July 31, 1974. Petitioner was terminated by the city of Auburn when PEP funds were discontinued.

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fractured his elbow while participating in the conditioning class. Pursuant to Wash. Rev. Code Ann. sec. 41.26.120 (Supp. 1974), petitioner applied for disability benefits.

Initially the city of Auburn Disability Board (the Board) determined that petitioner was not covered under the Law Enforcement Officers' and Fire Fighters' Retirement System (LEOFF System). Burgess appealed to the state of Washington which confirmed petitioner's coverage under the LEOFF System and sent the matter back to the Board. Because petitioner was employed by the Auburn Fire Department prior to September 30, 1977, he was covered by the LEOFF System and entitled to benefits from the Washington State Department of Retirement Systems. Wash. Rev. Code Ann. sec. 41.26.005 (Supp. 1974).

On rehearing, the Board found that petitioner was disabled for duty as a fire fighter starting November 15, 1973, and that the disability was not incurred in the line of duty. Petitioner began receiving disability retirement benefits pursuant to Wash. Rev. Code Ann. sec. 41.26.130 (Supp. 1974) in 1975.⁴ These

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Wash. Rev. Code Ann. sec. 41.26.130 (Supp. 1974) provides for payment:

computed as follows: (a) A basic amount of fifty percent of final average salary at time of disability retirement, and (b) an additional five percent of final average salary for each child as defined in RCW 41.26.030(7), (c) the combined total of subsections (1)(a) and (1)(b) of this section shall not exceed a maximum of sixty percent of final average salary.

(footnote continued)

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amounts were excluded from gross income by petitioner under section 104(a)(1).

The Commissioner denied the exclusion for the years 1978, 1979, and 1980 resulting in additional tax of \$2,341, \$2,922 and \$4,026, respectively. The sole basis for the issuance of the two notices of deficiency in this case was the Commissioner's determination that pension benefits received by petitioner in 1978, 1979, and 1980 were not excludable from income under section 104(a)(1).

OPINION

The taxation of personal injury payments is governed principally by section 104. Section 104(a)(1) provides an exclusion from gross amounts of "amounts received under workmen's compensation acts as compensation for personal injuries or sickness." However, benefits need not be received under a statute defined as a workmen's compensation act to qualify for this exclusion. Section 1.104-1(b), Income Tax Regs., excludes amounts received "under a statute in the nature of a workmen's compensation act which provides compensation to employees for personal injuries or sickness incurred in the course of employment."

(footnote continued from previous page)

Whether one is receiving benefits for duty related injury or non-duty related injury, the amount of the benefit does not differ for an award under Wash. Rev. Code Ann. sec. 41.26.120 (Supp. 1974).

Respondent argues that the LEOFF System is not "in the nature of a workmen's compensation act" and that the benefits petitioner received thereunder are includable in gross income. We agree with respondent that the LEOFF System as far as providing benefits under Wash. Rev. Code Ann. sec. 41.26.120, supra, is not "in the nature of a workmen's compensation act." Therefore, we need not reach the issue of whether petitioner's injury was incurred in the line of duty.

We begin our inquiry by examining the statutory schemes under which the state of Washington compensates its work force for injury or sickness.⁵

The Washington Workmen's Compensation Act, Title 51, Wash. Rev. Code Ann. sec. 51.32.010 (Supp. 1974) specifically limits coverage of the act to "[e]ach worker injured in the course of his or her employment." (Emphasis added.) However, police and fire fighters are not covered under the Washington Workmen's Compensation Act. Title 51 of the Wash. Rev. Code Ann. sec. 51.12.050 (Supp. 1974) provides that:

Whenever and so long as, by state law, city charter, or municipal ordinance, provision is made for employees or peace officers injured in the course of employment, such employees shall not be entitled to the benefits of this title * * *.

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We concern ourselves only with those provisions of the Law Enforcement Officers' and Fire Fighters' Retirement System Act (Title 41, Chapter 41.26 of the Wash. Rev. Code Ann. (Supp. 1974)) (LEOFF System) which apply to police and fire fighters who have established membership in the retirement system before September 20, 1977. See n. 7, infra.

Such provision is found for law enforcement officers and fire fighters in Title 41, Chapter 41.26, Wash. Rev. Code Ann. (Supp. 1974) (the LEOFF System), thereby excluding them from coverage under the Washington Workmen's Compensation Act, supra.⁶ Hunter v. Department of Labor & Industries, 19 Wash. App. 473, 576 P.2d 69 (1978).

Disability retirement payments are specifically provided under the LEOFF System in Wash. Rev. Code Ann. sec. 41.26.120, supra, subject only to the requirements of Wash. Rev. Code Ann. sec. 41.26.005 (Supp. 1974), that "[t]he provisions of the following sections of this chapter shall apply only to persons who establish membership in the retirement system on or before September 30, 1977." Petitioner established membership in the retirement system before September 30, 1977. As a result, he falls under the LEOFF System and is eligible to receive benefits from the Washington State Department of Retirement Systems under the authority of Wash. Rev. Code Ann. sec. 41.26.120, supra.⁷

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All police and fire fighters who do establish membership in the retirement system on or before September 30, 1977 (pre-1977 members) receive benefits under the LEOFF System from the Washington State Department of Retirement Systems. Those establishing membership in the LEOFF System after September 30, 1977, and who are disabled in the line of duty, receive benefits from the Washington State Department of Labor and Industries under Title 51 of the Revised Code of Washington, the general Washington Workmen's Compensation Act. See Wash. Rev. Code Ann. secs. 41.26.410, 41.26.480 (Supp. 1974).

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See n.6, supra.

Wash. Rev. Code Ann. sec. 41.26.120, supra, states in pertinent part:

Any member, regardless of his age or years of service may be retired by the disability board, subject to approval by the director as hereinafter provided, for any disability which has been continuous since his discontinuance of service and which renders him unable to continue his service, whether incurred in the line of duty or not. * * * [Emphasis added.]

It is this section that we focus on in our determination of whether petitioner's benefits are excludable from gross income because they arise from a statute "in the nature of a workmen's compensation act."

A statute is "in the nature of a workmen's compensation act" if it allows disability payments only for duty-related personal injury or sickness. Riley v. United States, 140 Ct. Cl. 381, 156 F. Supp. 751, 752 (1957); Haar v. Commissioner, 78 T.C. 864, 868 (1982), affd. per curiam 709 F.2d 1207 (8th Cir. 1983); Dyer v. Commissioner, 71 T.C. 560, 562 (1979). See also Rutter v. Commissioner, 760 F.2d 466, 468 (2d Cir. 1985), affg. a Memorandum Opinion of this Court.⁸ Although the LEOFF System is in lieu of coverage for police and fire fighters under the Washington Workmen's Compensation Act, supra, it does not become "in the nature of a workmen's compensation act" unless benefits are provided solely for work related injuries. Riley v. United States, supra; Haar v. Commissioner, supra; and Dyer v. Commissioner, supra.

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Cf. Clifford v. Commissioner, T. C. Memo. 1984-426.

In Haar v. Commissioner, supra, we determined that the Civil Service Retirement Act was not a statute in the nature of a worker's compensation act because it provided for disability payments regardless of whether the injury or sickness occurred on-duty or off-duty. Thus, payments received thereunder were not excluded under section 104(a)(1). Similarly, petitioner's payments flow from a statute which provides benefits for police and fire fighters, without regard to whether the injury is non-duty or duty-related.⁹

A statute with a dual purpose of providing workmen's compensation benefits and retirement benefits may meet criteria for exclusion of benefits under section 104(a)(1). That is, if particular benefits can be received only for duty related injury or sickness, it will then qualify as a payment from a statute

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Although Wash. Rev. Code Ann. sec. 41.26.120 (Supp. 1974) provides disability retirement funds for disability whether incurred in the line of duty or not, it also requires "[t]hat in any order granting a disability retirement allowance the disability board shall make a finding of whether or not the disability was incurred in the line of duty." Wash. Rev. Code Ann. sec. 41.26.120(2), supra.

Pursuant to awarding petitioner his benefits, the city of Auburn Disability Board made a finding that petitioner's injury was not sustained in the line of duty. However, petitioner contests this finding as being in error. Petitioner misses the point with this argument because our focus is on the statute itself. Under Wash. Rev. Code Ann. secs. 41.26.120 and 41.26.130, supra, petitioner receives the same benefits whether his injury or sickness is duty related or not.

"in the nature of a workmen's compensation act." Riley v. United States, supra; Frye v. United States, 72 F. Supp. 405 (D. D.C. 1947); Take v. Commissioner, 82 T.C. 630 (1984).

In Riley v. United States, supra, the Court of Claims considered District of Columbia Code, D.C. Code Ann. sec. 4-507 (1951), which provides policemen retirement pay for disability contracted in the line of duty.¹⁰ The same section provides a pension for the widow of any policeman who, before or after retirement, dies from any cause at all. In considering whether the widow's pension was excludable under section 104(a)(1), the court stated that:

[T]he provision in the code for pensions for widows of policemen does not make their payment dependent upon the cause of the husbands' deaths. If the plaintiff's husband had died of natural causes, her pension would have been the same as it was, and as it would have been if he had in fact been, before his death, retired for disability. [Riley v. United States, 140 Ct.Cl. at 382, 156 F. Supp at 752.]

Thus, because there was no differentiation under the statute itself as to the nature of the pension the widow received, these benefits could not be excluded under section 104(a)(1). Yet, the disability payments to a policeman injured in the line of duty were payments received from a statute in the nature of a

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The benefits received under this section as disability pay for policemen were determined to flow from a statute "in the nature of a workmen's compensation act." See Frye v. United States, 72 F. Supp. 405 (D. D.C. 1947).

workmen's compensation act. Therefore, D.C. Code Ann. sec. 4-507 (1951) is a dual purpose statute providing workmen's compensation benefits and non-workmen's compensation benefits.

Wash. Rev. Code Ann. sec. 41.26.120 (Supp. 1974) is unlike the District of Columbia statutes considered in Riley. Section 41.26.120 supra, provides benefits which are similar only to the widow's benefits under the District of Columbia statute. Like the widow's benefits, Wash. Rev. Code Ann. sec. 41.26.120, supra, provides benefits which are not dependent on whether an injury occurred in the line of duty or not. Thus, the statute at issue in this case is not a dual purpose statute within the meaning of Riley.

The Riley decision and those that have followed Haar v. Commissioner, 78 T.C. 864 (1982) and Take v. Commissioner, supra,¹¹ have agreed that in order for a statute to be in the nature of a workmen's compensation act, payments arising thereunder must be paid only as a result of a disability incurred in the line of duty. These decisions are consonant with the accepted purpose and policy of workmen's compensation. "[T]he purpose of workmen's compensation statutes is to provide benefits to victims of work connected injuries and to ultimately place the cost of such injuries on the consumer." Take v. Commissioner, supra at 635. (Emphasis added.)

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Cf. Clifford v. Commissioner, T.C. Memo. 1984-426; Debiasi v. Commissioner, T.C. Memo. 1983-161.

Petitioner and the state of Washington have been unable to convince us that Wash. Rev. Code Ann. sec. 41.26.120, supra, which provides benefits for injury incurred "in the line of duty or not," is "in the nature of a workmen's compensation act" for Federal tax purposes. See Welch v. Helvering, 290 U.S. 111 (1933).

Because we have held that the Law Enforcement Officers' and Fire Fighters' Retirement System Act is not "in the nature of a workmen's compensation act," as far as providing benefits under Wash. Rev. Code Ann. sec. 41.26.120, supra, we need not reach the question of whether petitioner's injuries were incurred in the line of duty. Accordingly,

Decisions will be entered
for the respondent.

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T. C. Memo. 1986-229

UNITED STATES TAX COURT

JOHN W. HOUGH AND LOUISE C. HOUGH, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 22200-82.

Filed June 5, 1986.

John W. Hough, for the petitioners.

Vikki L. Pryor, for the respondent.

MEMORANDUM OPINION

KÖRNER, Judge: Respondent determined a deficiency of income tax against petitioners with respect to their calendar year 1977 in the amount of \$33,568.68. The sole issue presented for our determination is whether a loss suffered by petitioner John W.

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Hough in 1977, on account of the worthlessness in that year of a bad debt, should be treated as a fully deductible business bad debt under the provisions of section 166(a),^{1/} or should be treated as a nonbusiness bad debt within the meaning of section 166(d), and therefore deductible only as a short-term capital loss, under the provisions of section 1211.

Many of the facts herein were stipulated, and such facts are incorporated herein by this reference.

At the time the petition herein was filed, petitioners were residents of Lake Forest, Illinois. They filed a joint individual income tax return for the year 1977.

Petitioner John W. Hough (hereinafter "petitioner") was licensed to practice law in Illinois in 1952 and has thereafter continuously practiced law in Chicago, Illinois, except for a period of military service between November 1953 and March 1957. In the years 1965 through 1976, he was a partner in the Chicago law firm of Keck, Mahin & Cate.

General Alloys Company (hereinafter "GA"), was a corporation founded in 1922 by one H.H. Harris, and was for a number of years engaged in the foundry business of producing heat and corrosion resistant high alloy castings. Mr. Harris served as president and chief executive officer of GA from its founding until his death on June 28, 1965. In the early 1930's, Mr. Harris caused

^{1/} All statutory references are to the Internal Revenue Code of 1954, as in effect in the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise noted.

petitioner's father, Charles F. Hough, to be retained as legal counsel to GA and to become a member of its Board of Directors, positions held by the elder Mr. Hough until his death in 1968.

Upon the death of Mr. Harris in 1965, petitioner became the sole executor of his estate, which included 57,145 shares of GA stock. Upon the conclusion of the administration of that estate, its remaining assets, including said stock, were transferred to the H.H. Harris Residuary Trust, which is now a charitable trust known as the H.H. Harris Foundation. Petitioner has continuously served as the sole trustee of the H.H. Harris Residuary Trust and the resulting H.H. Harris Foundation, which has continued to hold 57,145 shares of GA common stock.

Petitioner was elected to the board of directors of GA in July 1965, and continued to serve in such capacity until December 30, 1973. He served as chairman of the board of directors of GA for the period February 1, 1969 to December 30, 1973. He also served as chairman of a three-man executive committee of the board of directors of GA for the period September 20, 1969 to December 30, 1973, and served as chief executive officer and chief operating officer for GA for the periods February 1, 1971 to May 15, 1971 and October 15, 1972 to December 30, 1973.

In addition to the above positions which petitioner held with GA, petitioner's law firm of Keck, Mahin & Cate served as counsel to GA for the years 1965 through 1976, and also served as

counsel to GA's wholly owned subsidiary, Hanford Foundry Company (hereinafter "Hanford") for the period 1969 through 1972. All compensation for petitioner's services, whether as counsel to the company, corporate officer, or director, were billed by and paid to petitioner's law firm. For the years 1965 through 1969, the total fees and reimbursed expenses received by the law firm from GA annually ranged from a low of \$1,650 to a high of \$5,402.79. No fees were received from GA in the years 1970 through 1972, although during these three years expenses were reimbursed to the law firm by GA in the total amount of approximately \$8,750. As of July 1, 1971, GA owed the law firm \$41,250 in fees and \$4,631.25 for out of pocket disbursements. Although GA and Hanford were clients of petitioner's law firm, they were not major or principal clients.

The foundry business of GA, since its inception, had been conducted in Boston, Massachusetts. GA acquired Hanford as a wholly owned subsidiary at the end of 1968, and, in January 1970, GA discontinued its foundry operations in Boston and moved those operations to the facilities of Hanford in San Bernardino, California. This move, however, was apparently not successful from a business standpoint, since the two product lines of GA and Hanford did not mix well. Accordingly, GA sought to move its foundry operations elsewhere, and, in the latter part of 1970, began operations at the facilities of Castwell Company (hereinafter "Castwell"), in Fort Scott, Kansas. GA desired to purchase

the operating assets of Castwell but, because of business vicissitudes and large losses, GA was unable to borrow the necessary money from any outside source.

Accordingly, on July 1, 1971, petitioner loaned GA the sum of \$132,000 in return for a note, which was secured by a pledge agreement by GA with respect to certain royalties receivable by it under a license agreement. The proceeds of this note were used by GA, to the extent of \$130,750, for the purpose of acquiring the operating assets of Castwell.

Beginning in May 1972, payments were commenced on the note until total payments of \$62,272.47 were made. The unpaid balance of the note, in the amount of \$69,727, became worthless in 1977.

GA's foundry operations at Castwell were short lived, and after 1971, GA became inactive, with its remaining assets consisting principally of its stock in Hanford, which in turn went through a bankruptcy reorganization under Chapter 11 of the Bankruptcy Act, beginning in May 1973.

At the time petitioner made his loan to GA, petitioners individually owned 11,200 shares of GA common stock, with a cost price of \$46,375, and a market value of \$39,200. In November 1971, petitioners acquired additional shares of GA stock, bringing their total ownership up to 15,000 shares, and their total cost up to approximately \$60,000. At July 1, 1971, the stock of GA was publicly held, with 546,895 shares outstanding.

In their joint individual income tax return for 1977, petitioners claimed an ordinary loss deduction of \$69,727 as a business bad debt, on account of the worthlessness of the remaining balance of petitioners' loan to GA. Upon audit, respondent, while acknowledging the amount and the date of the worthlessness of the debt, determined that the deduction was allowable only as a nonbusiness bad debt, and was therefore deductible only as a short-term capital loss, subject to the restrictions of section 1211.

The dispute between the parties, then, is whether the bad debt in question here is to be treated as a business bad debt or a nonbusiness bad debt under the provisions of section 166. In resolving this question, the correct legal standard has been laid down by the Supreme Court in United States v. Generes, 405 U.S. 93 (1972), rehearing denied 405 U.S. 1033 (1972). In that case, having a remarkable similarity to the case at bar, the Court said:

The fact responsible for the litigation is the taxpayer's dual status relative to the corporation. Generes was both a shareholder and an employee. These interests are not the same, and their differences occasion different tax consequences. In tax jargon, Generes' status as a shareholder was a nonbusiness interest. It was capital in nature and it was composed initially of tax-paid dollars. Its rewards were expectative and would flow, not from personal effort, but from investment earnings and appreciation. On the other hand, Generes' status as an employee was a business interest. Its nature centered in personal effort and labor, and salary for that endeavor would be received. The salary would consist of pre-tax dollars.

Thus, for tax purposes it becomes important and, indeed, necessary to determine the character of the debt that went bad and became uncollectible. Did the debt center on the taxpayer's business interest in the corporation or on his nonbusiness interest? If it was the former, the taxpayer deserves to prevail here.

* * *

We conclude that in determining whether a bad debt has a "proximate" relation to the taxpayer's trade or business, as the Regulations^[2/] specify, and thus qualifies as a business bad debt, the proper measure is that of dominant motivation, and that only significant motivation is not sufficient. * * * [405 U.S. 93, 100-101, 103; citations omitted.]

In determining what petitioners' dominant motivation was in making the loan to GA under the above legal standard, the question presented is factual, and petitioner has the burden of proving that his dominant motivation was business related, as opposed to nonbusiness. See Putoma Corporation v. Commissioner, 66 T.C. 652, 673 (1976), affd. 601 F.2d 734 (5th Cir. 1979).

We hold that petitioner has failed to carry his necessary burden of proof on this issue. The only witness at trial was petitioner himself. On the question of his motivations in making the loan to GA, he testified as follows:

Q. Well, can you testify what your motivations were?

A. My motivations were, one, to save the investment of the trust that I served, the Harris Residuary Trust, to preserve my investment so that also generate fees in the future for myself as a lawyer for not only General Alloys Company, Hanford

^{2/} The reference in the quotation is to sec. 1.166-5, Income Tax Regs.

Foundry Company and the H.H. Harris Residuary Trust. And I would have to also say another motivation I had was to save the jobs of about 250 people at Hanford Foundry Company as employees. That was a true motivation to me.

In addition, before the instant case was begun, and while it was still under audit by respondent, petitioner wrote a letter to respondent, in reply to a query from the latter as to his dominant motives for making the loan, in which petitioner said the following:

The dominant motives for making the loan were that besides being Chairman of the Board of General Alloys Company, I had a substantial stock investment in the company as well as indirectly held as Trustee another substantial investment in the company. * * *

It is apparent from the above quotations that petitioner had a mix of motives in making the loan to GA. We cannot find that the dominant motive in making the loan was a directly connected business interest of petitioner. There is no evidence in this record that petitioner was in the money-lending business. Further, given the fact of the very modest fees which GA paid for all the various services which petitioner performed as chief executive officer, chief administrative officer, chairman of the board of directors, and counsel to the company (and there were no such fees paid in 1970, 1971 or 1972) as compared to the substantial stock investment which petitioners had in GA, we cannot believe that petitioner's dominant motivation in making the loan was to protect a source of income as a corporate

employee or counsel to the company; and this is especially true when it is noted that all such fees went to petitioner's law firm in which he would only realize a share corresponding to his partnership interest (not disclosed in this record).

We note one final matter. At the conclusion of trial herein, the Court directed that simultaneous briefs be filed by the parties, together with simultaneous reply briefs. This was a direction by the Court that the parties marshal what they considered to be the relevant facts and legal arguments and present them to the Court, for its assistance in resolving the issues presented. Pursuant to this direction, petitioner had a obligation to assist the Court by organizing the material presented at trial. Cf. Stringer v. Commissioner, 84 T.C. 693 (1985); Primoff v. Commissioner, T.C. Memo. 1985-562. Although respondent filed a brief in accordance with the Court's instruction, petitioners filed none. Under the circumstances, we would be justified in deciding this case in favor of respondent on the basis that petitioners' failure to file a brief constituted a concession of the issue presented. See Calcutt v. Commissioner, 84 T.C. 716, 721-722 (1985); Bender v. Commissioner, T.C. Memo. 1985-375; Stonegate of Blacksburg, Inc. v. Commissioner, T.C. Memo. 1974-213. We forebear to do so in this case, but we do decide the disputed issue against petitioners because of their failure to satisfy their necessary burden of proof.

Decision will be entered
for the respondent.

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T. C. Memo. 1986-230

UNITED STATES TAX COURT

KENNETH D. HERNDON AND TONYA HERNDON, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 4262-80.

Filed June 9, 1986.

J. R. Blumrosen, for the petitioners.

A. Shawn Noonan, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

GERBER, Judge: The Commissioner determined deficiencies in petitioners' Federal income taxes for their taxable year 1973 in the amount of \$8,322.71 and for their taxable year 1974 in the amount of \$800.22. After concessions, the only remaining issue

in this case is whether the proceeds from the sale of petitioners' cotton in the amount of \$33,858.91 is income to petitioners in the calendar tax year 1973 or 1974.¹

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts, oral supplemental stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

Kenneth D. Herndon (petitioner) and his wife, Tonya Herndon, filed joint Federal income tax returns for the calendar years 1973 and 1974, during which time they maintained their books and records and reported their income and expenses based upon the cash receipts and disbursements method of accounting. Petitioners resided at Anson, Texas, during all periods involved in this case.

During 1973, petitioner's primary occupation was farming, and cotton was petitioner's main crop. Although cotton is a major "cash crop" in West Texas, the farmers are at the mercy of the limited and erratic rainfall in that area. The time of planting cotton is dependent upon the timing and quantity of

¹ Petitioners on brief and in their petition contest \$38,551.04 of proceeds, not \$33,858.91. The former amount apparently consists of \$4,692.10 of proceeds from cottonseed sales and \$33,858.91 of proceeds from cotton sales reported in 1974, and not 1973. (Evidently, petitioners make a three-cent error in their addition: $\$4,692.10 + \$33,858.91 = \$38,551.01$, not \$38,551.04.) Prior to the filing of the briefs, however, the parties stipulated that the amount of proceeds in controversy was \$33,858.91. See Rule 91(e), Tax Court Rules of Practice and Procedure.

spring rain. If the spring rain is late in one year and early in the next year the result may be two harvests in the same taxable year. Further exacerbating this distortion in income is the lack of offset of expenses of farming attributable to the first year's crop which is harvested in the early portion of the next taxable year. To counteract these factors, the cotton farmers of the West Texas area have attempted methods of deferring receipt of proceeds from a second harvest in a single year. Over the years there has been tax litigation concerning these phenomena. This case is one in a relatively large succession of "deferral cases."

On August 28 and 29, 1973, petitioner entered into written contracts with Hodge & Fields Cotton Co., Inc. (H&F), which provided that petitioner would grow and sell 158 bales of cotton, at specified prices.² These contracts were entered into prior to

² The contracts were identical, except for the dates, acreage, number of bales, farm number, purchase number, number of points over the 1973-1974 USDA Government loan, and witnesses. All contracts were entitled "1973 COTTON PURCHASE AND SALES AGREEMENT." The contracts were "by and between HODGES & FIELDS COTTON CO. INC. * * * BUYER, and K.D. Herndon, * * * SELLER." The contracts were signed "Hodges & Fields Cotton Co., Inc., By: Dennis Brown" and "ACCEPTED: By: Kenneth Herndon."

The contracts stated that H&F agreed to purchase and petitioner agreed to deliver an approximate number of bales of cotton produced on the farm specified therein. The contracts specified the price to be paid in terms of points above the USDA Government loan, and contained other clauses regarding: Weight, compliance, cooperation, warranty and inspection. The contracts did not provide for time of delivery or method of payment.

the time that the cotton was harvested.³ After concessions, a \$33,858.91 payment under these contracts is the amount in dispute.

H&F was primarily engaged in the cotton merchandising business and maintained its headquarters in Abilene, Texas. As a cotton merchant, H&F acted as an intermediary between cotton producers and large consumers of cotton by purchasing cotton from farmers and selling the cotton to shippers. Customarily, H&F would first agree to sell at a given price and then offer to buy a like amount of cotton from a producer at a slightly lower price. The difference in price was H&F's gross profit.

All of the cotton covered by the forward contracts was ginned at the Farmers Cooperative Gin (the Gin).⁴ The Gin's primary business in 1973 was to gin cotton, but the Gin also served as a middleman between farmers and cotton merchants. Petitioner was an officer and stockholder patron of the Gin. Raymond McLaren (McLaren) was manager for the Gin, and Dennis Brown (Brown) was the bookkeeper.

³ The contracts will sometimes be referred to as the "forward contracts." Cotton forward contracts are contracts in which farmers agree to sell a specified amount of cotton acreage at a given price, and are entered into in advance of delivery.

⁴ During 1973 and 1974, the Gin was a cooperative gin within the meaning of sec. 521, I.R.C. 1954, as amended. Therefore, the Gin was required to distribute all income to its patrons at the end of each fiscal year.

McLaren had authority to make day-to-day business decisions on behalf of the Gin, and regularly spoke with patrons; Brown wrote payroll checks, and handled some of the cotton sold through the Gin. One of Brown's duties as a bookkeeper was filling in both cotton purchase and sales contracts and deferred payment contracts. Brown had full authority to sign the deferred payment contracts on behalf of the Gin. Brown, however, only entered into cotton purchase and sales contracts after cotton merchants such as H&F authorized him to act on their behalf. Before entering into any cotton purchase and sales contracts, Brown contacted H&F to make sure H&F wanted to purchase cotton at the terms requested, unless Brown had talked to H&F earlier in the day.

On October 29 and December 4, 1973, petitioner entered into deferred payment contracts with respect to portions of the cotton covered by the August contracts between H&F.⁵ The deferred

⁵ The deferred payment contracts were identical, except for the contract dates, the payment dates, and the invoice numbers. The contracts were entitled "DEFERRED PAYMENT CONTRACT." They were signed by "Grower - Kenneth Herndon" and "Farmers Co-op Gin Anson, Texas, By Dennis Brown." The contracts provided that the grower (petitioner) may deliver cotton to the Gin under the following terms: title would pass to the Gin upon delivery of the cotton; the "Price Advance" made to the grower "shall be fixed at the date the cotton is delivered" to the Gin, with the marketing of the cotton done at the Gin's discretion; "[r]egardless of the time when cotton delivered under the Deferred Payment Contract is sold by Farmers Co-op Gin, it is agreed by the parties hereto that no Advance or Payment of Any Kind will be made to the Grower prior to the date specified below;" the Gin must advance the grower the agreed upon price within 7 days of the date specified below. The dates on the contracts were Jan. 1, 1974, and Jan. 2, 1974.

payment contracts used in this case were modified forms of some blank deferred payment contracts left at the Gin by H&F. McLaren deleted H&F's name from those contracts and substituted the Gin's name.⁶

The deferred payment contracts purported to sell cotton to the Gin, but neither of the parties intended for the Gin to actually purchase any cotton. The decision to defer payment was solely petitioner's, as was the decision of how much of the proceeds to defer. The only time that petitioner talked directly with H&F about the possibility of deferring some sales proceeds of the August contracts was during the negotiations of such contracts.

During November and December of 1973, petitioner delivered to the Gin the cotton covered by the deferred payment contracts. Petitioner received payment from the Gin in January 1974.⁷ The Gin received the same commission price per bale of cotton whether or not the payment was deferred but, if payment was deferred, had the use of the proceeds during the interim period. Petitioner was not aware that H&F turned the monies over to the Gin until after H&F had done so.

⁶ This allowed the Gin to receive the proceeds and realize interest from the purchase of interest-bearing certificates during the interim period.

⁷ H&F paid petitioner directly for all cotton not covered by a deferred payment contract, and paid the Gin for all cotton so covered. Normally, H&F paid the farmers (hereinafter sometimes referred to as the "producers") directly for the cotton, even when the payments were deferred.

Petitioner was not the only farmer who decided to defer payment in 1973. Many other members of the Gin also entered into such agreements. All deferred payment contracts were handled the same way.

After the Commissioner audited one Gin member who had entered into such deferred payment contracts, Frank Lollar (Lollar), a meeting of the Gin membership was held. Among those present at the meeting were Lollar, petitioner, Stephen Johnson (Johnson), and Borden Duffel (Duffel). Johnson, an Internal Revenue Service agent, had conducted the Lollar audit. Duffel was Lollar's accountant, as well as accountant for H&F, the Gin, and some other Gin members. Discussion of selecting a test case for all Gin members using the deferred payment contracts ensued, and Duffel suggested using the Lollar case. Johnson apparently agreed.⁸ The membership of the Gin approved the selection at the meeting. There was no further discussion of this decision, and the agreement was not reduced to writing.

The Lollar case proceeded to trial in the United States District Court for the Northern District of Texas. A jury verdict was returned in favor of Lollar.⁹ The only question addressed by the jury was: "Do you find by a preponderance of the evidence that the Farmers Cooperative Gin of Anson was not

⁸ Johnson admitted he was not authorized to enter into such an agreement, and at trial could not remember whether such an agreement had ever been discussed.

⁹ See Lollar v. United States, an unreported case (N.D. Tex. 1978, 42 AFTR 2d 78-5882, 78-2 USTC par. 9502).

acting as agent for the plaintiff Lollar in receiving and holding the proceeds in question from the sale of his cotton during the calendar years 1972 and 1973?" The jury answered: "It was not acting as agent for plaintiff Lollar in receiving and holding such proceeds."

OPINION

The issue we must decide is whether the proceeds from the sale of cotton are taxable income to petitioner in 1973 or 1974. Respondent argues that the Gin was petitioner's agent and that the proceeds are taxable in 1973, the year they were received from H&F. Alternatively, respondent argues that petitioner was in constructive receipt of the proceeds in 1973. Petitioner argues that the Gin was acting as H&F's agent and not as petitioner's agent in receiving the sales proceeds, and that he was not in constructive receipt of the proceeds in 1973, since they were not available to him until 1974.¹⁰

¹⁰ Petitioner initially contended that the law of "res judicata, collateral estoppel," or "stare decisis" mandated a decision in his favor. On brief, petitioner has since conceded this point. In any event, we find that these arguments lack merit. See Commissioner v. Sunnen, 333 U.S. 591 (1948).

Additionally, petitioner initially contended that the alleged oral agreement between Duffel and Johnson prohibited the Government from pursuing this action. Petitioner has since conceded this point as well. We consider this argument also as lacking merit. See Boulez v. Commissioner, 76 T.C. 209 (1981).

Accordingly, we do not further address these contentions.

A finding for respondent on either of his theories would render the proceeds taxable in 1973. We agree with respondent that the Gin was acting as petitioner's agent, and therefore that the proceeds were taxable in 1973.¹¹

It is undisputed that the Gin received the proceeds in 1973, and that if the Gin was acting as petitioner's agent, the general rule that receipt by an agent is receipt by the principal applies. See Williams v. United States, 219 F.2d 523 (5th Cir. 1955). Under the law of agency in Texas, a person may be an agent for one principal for one part of a transaction, and an agent for another principal for the remainder. Arnwine v. Commissioner, 696 F.2d 1102, 1108 (5th Cir. 1983), revg. 76 T.C. 532 (1981); 1 Restatement, Agency 2d, sec. 14L (1957).

The critical aspect of this transaction is whether the Gin was acting solely on petitioner's behalf and at his direction with respect to the distribution of the sales proceeds. Arnwine v. Commissioner, supra at 1109. We find that the controlling facts here are indistinguishable from those in Arnwine and, accordingly, find for respondent.¹²

The Arnwine taxpayer, Mr. Arnwine, was also a West Texas cotton farmer with loosely defined delivery and deferred payment contracts. Mr. Arnwine entered into forward contracts to sell

¹¹ We, therefore, need not consider respondent's alternative argument that petitioner constructively received the proceeds.

¹² Any appeal by petitioner would normally lie in the Fifth Circuit. See Golsen v. Commissioner, 54 T.C. 742, 756-758 (1970), affd. 445 F.2d 985 (10th Cir. 1971).

cotton with Mr. Wadlington, a representative of various cotton buyers. The buyers, through Mr. Wadlington, contacted Mr. Owens (owner of an independent gin) requesting information about cotton for sale. Mr. Owens, in turn, approached Mr. Arnwine. An agreement was reached between the parties.¹³

Subsequently, Mr. Arnwine entered into a deferred payment contract (covering the same cotton) with Mr. Owens. The contract did not mention the buyers and was not approved by them; it did not purport to alter any obligation to make payment for cotton upon delivery; and, it was made solely at Mr. Arnwine's direction and for his benefit.

The Fifth Circuit held that an agency relationship existed between Mr. Arnwine and the gin, and further, stated that the

¹³ The forward contracts executed by the parties were drafted by Mr. Wadlington. The contracts listed the gin as seller and Mr. Arnwine as grower. As the Fifth Circuit noted, however, we found (and this finding was not contested) that although the gin was named as a party, neither party intended that the gin actually buy cotton. Mr. Owens signed for the seller, Mr. Arnwine signed for the grower, and Mr. Wadlington signed for the buyer. See Arnwine v. Commissioner, 696 F.2d 1102 (5th Cir. 1983), revg. 76 T.C. 532 (1981).

case was indistinguishable from Warren v. United States, 613 F.2d 591 (5th Cir. 1980):¹⁴

The Tax Court attempted to distinguish Warren on the grounds that the Gin here provided "many more" services for the purchasers than did the gins in Warren and that the "purchasers involved here approached the Gin, whereas in Warren the seller sought the services of the gins to find purchasers for the cotton." Even if those statements were accurate, the factors described do not serve to distinguish Warren. The critical economic relationship between the taxpayer and the Gin relating to the distribution of the sales proceeds is in all material respects identical to that which this court in Warren found to be indisputably that of principal and agent. The taxpayer maintained full control of the disposition of the proceeds of his cotton, and the basic function of the Gin was to follow his instructions with respect to those proceeds. [Emphasis added. 696 F.2d at 1109-1110.]

¹⁴ In Warren v. United States, 613 F.2d 591 (5th Cir. 1980), the Fifth Circuit granted a judgment notwithstanding the verdict, reversing the jury verdict for the taxpayer. Like Mr. Arnwine and petitioner herein, that taxpayer was a cotton farmer in Texas.

Warren involved forward contracts and deferred payment contracts similar to those at hand. In Warren, the gin acted as an intermediary between producers and cotton buyers. Additionally, the gin would, at a farmer's request, collect the sales proceeds and hold the funds until the following year.

The court found, as a matter of law, that an agency relationship existed between the taxpayer and the gin. In making this determination, the court stated:

The Warrens instructed the gins to solicit bids, the Warrens decided whether to accept the highest price offered, and the Warrens determined whether or not to instruct the gins to hold the proceeds from the sale until the following year. The gins' role in the sale of the cotton was to adhere to the appellees' instructions. The Warrens were the owners of the cotton held for sale; the Warrens were in complete control of its disposition. [Warren v. United States, 613 F.2d at 593.]

The critical facts here are the same as in Arnwine: petitioner maintained full control over the proceeds until he chose to impose a self-limitation on the access; the Gin merely followed petitioner's instructions. The deferred payment contracts were executed by petitioner and the Gin, acting in its own name; the contracts were made solely at petitioner's direction and for his benefit. We therefore, on the basis of Arnwine, conclude that the relationship between petitioner and the Gin was one of principal and agent with respect to the distribution of the sales proceeds.¹⁵

To reflect the foregoing,

Decision will be entered under
Rule 155.

¹⁵ Additionally, we note that in this case petitioner was an officer and stockholder/patron of the Gin, and was entitled to a share of the Gin's yearly profits. Arnwine involved an independent gin.

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UNITED STATES TAX COURT

WILLIAM C. SAMPSON AND LUCILLE A. SAMPSON, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 3394-81.

Filed June 9, 1986.

William C. Sampson and Lucille A. Sampson, pro se.

Nancy B. Herbert, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

HAMBLEN, Judge: Respondent determined deficiencies in petitioners' Federal income taxes and additions to the tax as follows:

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<u>Year</u>	<u>Deficiency</u>	<u>Additions to Tax</u>	
		<u>Sec.6653(a)¹</u>	<u>Sec.6654(a)</u>
1975	\$7,138.45	\$356.92	\$308.25
1976	7,653.49	382.67	272.79
1977	7,998.50	399.93	284.62
1978	6,665.70	333.29	212.79
1979	8,915.90	445.80	371.38

After concessions,² the issues for decision are (1) whether this Court has jurisdiction to make a determination when such determination requires consideration of a party who is not before the Court; (2) whether timely notices of deficiency were issued to petitioners for taxable years 1975 and 1976; (3) whether income reported on the Federal income tax returns of The Lucille A. Sampson Pure Equity Trust is properly reportable by petitioners on their Federal income tax returns for the years at issue; (4) whether petitioners are liable for self-employment taxes in the amount determined by respondent under section 1401

1

All section references are to the Internal Revenue Code of 1954, as amended and in effect during the taxable years at issue. All rule references are to the Tax Court Rules of Practice and Procedure.

2

Petitioners expressly concede that the notice of deficiency issued by respondent for the taxable year 1977 was timely. In addition petitioners have not claimed error with respect to the investment tax credit amounts disallowed by respondent for taxable years 1976 through 1979, the trade or business expenses disallowed by respondent for taxable year 1975, or the depreciation deductions disallowed by respondent for taxable years 1977 through 1979. Consequently, these issues are deemed conceded. Rule 34(b)(4). In any event petitioners have introduced no evidence as to these items and have failed to meet their burden of proof. Rule 142(a).

for each of the years at issue; (5) whether petitioners are liable for an addition to the tax under section 6653(a) for each of the years at issue; (6) whether petitioners are liable for an addition to the tax under section 6654 for each of the years at issue; and (7) whether damages should be awarded to the United States under section 6673.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly. The stipulation of facts and attached exhibits are incorporated herein by this reference.

Petitioners resided in Middletown, Ohio, when they filed their petition in this case.

Petitioner William C. Sampson ("William") practiced as an osteopath during the years at issue. William rendered his osteopathic services through W. Clifford Sampson, Inc. (the "Corporation"). The Corporation was incorporated on September 15, 1975. The Corporation filed Forms 1120, U.S. Corporation Income Tax Returns, for the short taxable year September 15, 1975, through December 31, 1975, and thereafter for the successive calendar years through 1979. For the taxable year ending December 31, 1975, the Corporation reported "other deductions" nominated as "professional fees" in the amount of \$6,500.00. In succeeding taxable years the Corporation reported the following amounts as "Cost of goods sold" nominated as "professional services" or "professional fees":

<u>Year</u>	<u>Amount</u>
1976	\$23,765.24
1977	24,280.20
1978	24,296.00
1979	26,485.00

The Corporation reported no taxable income for any of its taxable years through 1978 and reported \$311.00 in taxable year 1979.

On April 1, 1975, petitioner Lucille A. Sampson ("Lucille"), as grantor, executed a trust agreement.³ The trust created by the agreement was nominated as "The Lucille A. Sampson Pure Equity Trust" (the "Trust"). The trustees named in the Trust agreement were Lelah M. Truxal and William. However, Lelah M. Truxal ceased to serve as a trustee and was replaced by Lucille and the two children of William and Lucille, Bruce and Diane. William, Lucille, Bruce and Diane served as trustees during each of the years at issue. These same persons were beneficiaries of the Trust during the years at issue.

The property transferred to the Trust on execution of the agreement was petitioners' residence. On April 10, 1975, the Trust purportedly executed an agreement with William. This document provided, in pertinent part:

3

Our use of the term trust is not to be construed as a finding or holding that the Lucille A. Sampson Pure Equity Trust is a trust which is valid for either Federal tax or State law purposes.

The TRUST, realizing full well that it cannot practise [sic] Osteopathy, wishes to obtain the services of Dr. W. C. Sampson as an Osteopathic Physician. Dr. W. C. Sampson desires to give his skill and expertise as an Osteopathic Physician to the Trust so that he may perform services on behalf of the TRUST.

The TRUST and Dr. W. C. Sampson do covenant and agree as follows:

1. The TRUST agrees to furnish the following to Dr. W. C. Sampson for his services as an Osteopathic Physician to the TRUST.

- a) The use of the TRUST properties with paid utilities for living and working quarters for other uses than TRUST use.
- b) The use of a telephone listed in his name for other than TRUST business, and payment of the telephone bill.
- c) The use of a leased automobile for other than TRUST business.

2. Dr. W. C. Sampson agrees to give his professional services to the TRUST for the above listed benefits of paragraph 1.

* * *

5. Dr. W. C. Sampson recognizes that the TRUST shall manage its business affairs exclusively and the relationship between the TRUST and Dr. W. C. Sampson shall be that of Independent Contractor.

On September 16, 1975, the Trust purportedly executed an agreement with the Corporation. This document provided, in pertinent part:

1. The TRUST agrees to furnish the expertise and knowledge of Dr. W. C. Sampson, D.O. to the COMPANY. The COMPANY accepts the expertise and knowledge of Dr. W. C. Sampson, D.O. The services to be provided shall be understood by both parties to consist of the skills denoted an Osteopathic Physician licensed by the State of Ohio.

2. The COMPANY cannot control or supervise the work or services to be performed by Dr. W. C. Sampson. The TRUST agrees that Dr. W. C. Sampson shall devote his time and effort to the business of the COMPANY and all remuneration earned belongs to the COMPANY.

3. The TRUST shall be compensated for the services of Dr. W. C. Sampson to the COMPANY, a fee equaling 82% per annum of the income earned for the COMPANY by Dr. W. C. Sampson. That fee, in part or in whole, shall be paid on demand of the TRUST. Any modification of this fee shall be in writing and agreed to by both parties.

The Trust filed Forms 1041, U.S. Fiduciary Income Tax Returns, for the short taxable year April 1, 1975, through December 31, 1975, and thereafter for the successive calendar years through 1979. In these returns the Trust reported the following amounts as income from the Corporation:

<u>Year</u>	<u>Amount</u>
1975	\$12,500.00
1976	23,765.24
1977	24,280.20
1978	24,296.00
1979	26,485.00

In addition the Trust reported business receipts in the following amounts:

<u>Year</u>	<u>Amount</u>
1975	\$18,049.70
1976	31,414.67
1977	38,222.73
1978	29,505.75
1979	28,993.00

During the same years the Trust claimed deductions relating to the maintenance and operation of the residence in which petitioners lived and for medical expenses for petitioners and their family. The Trust also reported net distributions to the beneficiaries in the following amounts:

<u>Year</u>	<u>William and Lucille</u>	<u>Children</u>
1975	\$1,958.69	\$ 839.44
1976	8,389.79	3,595.64
1977	5,532.94	2,371.28
1978	4,314.00	1,848.00
1979	3,733.00	1,600.00

The Trust reported no taxable income in any of its taxable years through 1979. The 1975 and 1976 Trust Federal income tax returns were prepared by Jay Q. Truxal, C.P.A.

Petitioners filed timely, joint Forms 1040, U.S. Individual Income Tax Returns, for the years 1975 through 1979. On these returns petitioners reported income from trust distributions identical to the amounts reflected as distributions to them by the Trust. In 1975 petitioners also reported income from a trade or business in the amount of \$5,646.29, and in 1979 petitioners also reported income from wages or salary in the amount of \$1,960.00. The only other income reported in any of these years were small amounts of interest income, an estate distribution in the amount of \$48.93, a taxable capital gain distribution in the amount of \$2.00, and automobile rental income. William reported his occupation as doctor or osteopath on each return. Petitioners' 1975 and 1976 Federal income tax returns were prepared by Jay Q. Truxal, C.P.A.

On January 26, 1981, respondent issued a notice of deficiency to petitioners relating to taxable years 1975 through 1979. The deficiencies reflected in the notice of deficiency were, in substantial part, due to income which respondent

maintains was improperly reported by the Trust. The income which respondent determined should have been reported by petitioners and not by the Trust was identical in amount to the income reported on the Trust returns without reduction except for the cost of merchandise.

In their petition filed on February 23, 1981, petitioners claimed that the full amount of the deficiencies and additions to tax determined by respondent are in controversy but did not present clear and concise assignments of error committed by respondent nor any facts on which such error might be based. Instead petitioners raised meritless arguments regarding the purported Constitutional "errors" committed by respondent and the "arbitrary" and "capricious" actions of respondent. The only issue of any merit raised in the petition is the timeliness of the notice of deficiency for the years 1975 through 1977.

As the case progressed, petitioners failed to make any meaningful attempt to cooperate in preparing this case for trial. On March 5, 1982, petitioners filed a motion characterized as a motion for grant of immunity which was denied on March 19, 1982. On April 16, 1982, petitioners filed a motion to produce which was denied on April 19, 1982. On April 26, 1982, petitioners filed a motion to compel answers to interrogatories which was withdrawn by motion granted October 18, 1983. On April 27, 1982, petitioners filed a motion for summary judgment claiming, in part, that respondent's action in issuing the notice of

deficiency was "ultra vires." This motion was denied by order dated November 8, 1984. Prior to the date of this order, petitioners had filed a motion to vacate the notice setting the hearing on their motion for summary judgment. This motion was denied on May 7, 1982. On May 14, 1982, petitioners filed yet another motion for summary judgment, this time based on their argument that the notice of deficiency as to the taxable years 1975 through 1977, inclusive, was untimely. This motion was denied by order dated November 8, 1984. On October 19, 1983, petitioners filed a motion to dismiss the case with prejudice to respondent. This motion was denied on October 21, 1983. On October 26, 1983, petitioners renewed their motions for summary judgment. These motions were denied by Order dated November 8, 1984. Finally, on December 10, 1985, petitioners filed a motion apparently seeking an order by the Court denying consideration of matters relating to the Trust. This motion was denied by Order dated January 23, 1986. Petitioners renewed their motion and the second motion was denied on February 4, 1986.

Petitioners are not unfamiliar with this Court. Currently, they have another case pending before the Court. As in this case, there is an issue relating to the Trust.

OPINION

Initially, we must consider petitioners' jurisdictional objection. Petitioners, in their "Motion to Dismiss" filed on December 10, 1985, raised a similar argument. By Order dated January 23, 1986, we denied petitioners' motion. In the accompanying Memorandum Sur Order we explained:

Our jurisdiction to make a determination is limited by statute. Sec. 7442, Internal Revenue Code of 1954, as amended. Except for certain declaratory judgment and disclosure actions, the issuance of a notice of deficiency or notice of liability is a prerequisite to Tax Court jurisdiction. Medeiros v. Commissioner, 77 T.C. 1255, 1260 (1981). However, the fact that we do not have jurisdiction to determine a particular taxpayer's liability does not preclude consideration of that taxpayer in relation to a determination of the liability of a taxpayer for which we do have jurisdiction. See, e.g., Lerner v. Commissioner, 71 T.C. 290 (1978); Malkan v. Commissioner, 54 T.C. 1305 (1970); Friedman v. Commissioner, 41 T.C. 428 (1963), affd. 346 F.2d 506 (6th Cir. 1965).

Here, we do not have jurisdiction to make a determination as to the fact or amount of any deficiency in the Federal income tax liability of the trust as the trust is not properly before us as a party. We may, however, to the extent relevant to the determination of any deficiency for the parties who are before us, consider issues relating to the trust.

There has been no change in our jurisdictional authority since the date of the Memorandum Sur Order, and we must reject petitioners' argument that we are without jurisdiction to consider issues relating to the Trust.⁴

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In a prior proceeding involving this case, we denied the Trust's petition to intervene. Sampson v. Commissioner, 81 T.C. 614 (1983). In that case we stated at 617-618:

In seeking to intervene herein, the trust is seeking to inject into the present case issues relating "to the rights
(footnote continued)

We must next consider petitioners' claim that the notice of deficiency was not timely as to 1975 and 1976. Petitioners have the burden of proving that the normal period of limitation expired prior to the issuance of the notice of deficiency, and respondent has the burden of proving the application of any exception to the normal period of limitation. Miami Purchasing Service Corp. v. Commissioner, 76 T.C. 818, 823 (1981); Robinson v. Commissioner, 57 T.C. 735, 737 (1972). Generally, the notice of deficiency must be issued within three years after the return was filed. Sec. 6501(a); sec. 6213(a). Section 6501(e) provides an exception to the general rule and states, in pertinent part:

(e) SUBSTANTIAL OMISSION OF ITEMS.--Except as otherwise provided in subsection (c)--

(1) INCOME TAXES.--In the case of any tax imposed by subtitle A--

(A) GENERAL RULE.--If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return, the tax may be assessed * * * at any time within 6 years after the return was filed. For purposes of this subparagraph--

(footnote continued from previous page)

and interests of the Trust, particularly, questions which address the very existence and propriety of the Trust." The trust also seeks to raise issues herein concerning the individual property rights and interests of trustees and beneficiaries, presumably including the present petitioners, in and to trust property. None of these matters, however, are properly before this Court as issues, nor do they form a necessary part of any of the issues which we must decide in rendering a decision in this case. [Footnote reference omitted.]

(i) In the case of a trade or business, the term "gross income" means the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown on the return) prior to diminution by the cost of such sales or services; and

(ii) In determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary or his delegate of the nature and amount of such item.

The Supreme Court enunciated the basic test which was codified in section 6501(e)(1)(A)(ii). Colony, Inc. v. Commissioner, 357 U.S. 28 (1958). In that case the Supreme Court stated:

We think that in enacting [section] 275(c) [now section 6501(e)] Congress manifested no broader purpose than to give the Commissioner an additional two years [now three years] to investigate tax returns in cases where, because of a taxpayer's omission to report some taxable item, the Commissioner is at a special disadvantage in detecting errors. In such instances the return on its face provides no clue to the existence of the omitted item. On the other hand, when, as here, the understatement of a tax arises from an error in reporting an item disclosed on the face of the return the Commissioner is at no such disadvantage. And this would seem to be so whether the error be one affecting "gross income" or one, such as overstated deductions, affecting other parts of the return. * * * [Emphasis added.]

Colony, Inc. v. Commissioner, supra at 36. We have further stated that "this does not mean simply a 'clue' which would be sufficient to intrigue a Sherlock Holmes" but "neither does it mean a detailed revelation of each and every underlying fact." George Edward Quick Trust v. Commissioner, 54 T.C. 1336, 1347 (1970), affd. 444 F.2d 90 (8th Cir. 1971). In some circumstances

a related tax return may be considered. See, e.g., Davenport v. Commissioner, 48 T.C. 921, 928 (1967); Roschuni v. Commissioner, 44 T.C. 80, 84 (1965).

Here, even assuming that the Trust returns are properly considered, petitioners' disclosure of the fact of income from the Trust was not sufficient to give respondent a clue as to the existence of additional omitted income. Neither the Trust returns nor petitioners' individual returns disclosed the fact that William was purportedly employed by the Trust as an independent contractor.⁵ The Trust returns did state that the Trust was engaged in a business, but did not identify which business it was engaged in. The only hint which respondent had that petitioners had omitted items of gross income was the fact that William's profession was listed as osteopath on petitioners' 1976 income tax return and yet there was no entry for income from salary or wages or trade or business income. We decline to find that this was a sufficient "clue" as to the existence of the omitted income.

The amount of gross income reported on the Trust income tax returns was \$12,500.00 as income from the Corporation and \$18,049.70 as business receipts in 1975 and \$23,765.24 as income from the Corporation and \$31,414.67 as business receipts in 1976.

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The fact that William was listed as a nominee in these returns was not sufficient to disclose the fact of employment as this designation could simply mean that bank accounts were held in his name.

As subsequently discussed, we have determined that this income was actually earned by William. The amount of gross income reported on petitioners' income tax returns was \$19,884.46 in 1975 and \$8,389.79 in 1976. Clearly, the amount omitted from petitioners' gross income was in excess of 25 percent of the amount of gross income stated in the returns. Respondent did not have a sufficient clue as to the omitted income. Consequently, the six year statute of limitations is applicable for petitioners' taxable years 1975 and 1976. Petitioners' returns are deemed to have been filed no earlier than April 15, 1976, and April 15, 1977, respectively, pursuant to section 6501(b)(1), and a notice of deficiency issued on January 26, 1981, is within six years of both dates.

We must next consider whether the income reported on the Federal income tax returns of the Trust is properly reportable on petitioners' individual income tax returns for each of the years at issue. This case presents yet another situation in which petitioners have used a trust device to avoid the incidents of taxation on their earnings. See, e.g., Hanson v. Commissioner, 696 F.2d 1232 (9th Cir. 1983); Schulz v. Commissioner, 686 F.2d 490 (7th Cir. 1982); Vnuk v. Commissioner, 621 F.2d 1318 (8th Cir. 1980); Vercio v. Commissioner, 73 T.C. 1246 (1980); Markosian v. Commissioner, 73 T.C. 1235 (1980).⁶

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Also see Whitesel v. Commissioner, T. C. Memo. 1983-9, affd. without published opinion 745 F.2d 59 (6th Cir. 1984).

A taxpayer cannot escape taxation by an assignment of his or her income to another entity. Lucas v. Earl, 281 U.S. 111, 114-115 (1930). A fundamental principle of our income tax laws is that income is taxed to the one who earns it, Commissioner v. Culbertson, 337 U.S. 733, 739-740 (1949), and taxation cannot be avoided by diverting the income to another entity, for example to a trust, as in the instant case. United States v. Basye, 410 U.S. 441, 450 (1973).

A key factor in determining whether compensation for services performed by an individual is in fact earned by the individual and not by a trust entity for which these services are purportedly performed is the existence of ultimate control and direction over the earning of the compensation. Vercio v. Commissioner, supra at 1254. The Courts will look beyond mere "paper transactions" which have no effect on economic reality. Markosian v. Commissioner, supra at 1241.

Here, it is clear that nothing was changed by the interposition of the Trust between petitioners and William's osteopathic practice except the manner and amount of income which petitioners reported for Federal income tax purposes. There is absolutely no evidence in the record that any formalities other than signing the documents which were admitted into evidence and submitting separate Federal income tax returns for the Trust were undertaken. The persons who were intended to benefit from the Trust were also the trustees of the Trust. There was no

independent fiduciary who might require that the Trust terms were complied with. In addition petitioners continued to live in their residence which had been transferred to the Trust and to pay their living expenses, albeit now from the Trust. Finally, it is clear that William had complete control and direction over the income which was earned by his osteopathic services.

Pursuant to the purported agreement between the Trust and the Corporation, the Trust was to receive 82 percent of the income earned by William. The purported agreement between the Trust and William essentially provided that the Trust would pay petitioners' living expenses as compensation for the services which he provided to the Corporation. Under these arrangements, it would be William's decision as to whether he wished to perform the services which would generate income for the Corporation and the Trust and ultimately result in the payment of petitioners' living expenses.

Under these circumstances we can only conclude that William was the true earner of the income reported on the Federal income tax returns of the Trust. Although the Trust claimed deductions which were disallowed by respondent, petitioners offered no evidence that these deductions represented anything other than nondeductible, personal expenditures. Consequently, we sustain respondent's determination that William actually earned the income reported on the income tax returns of the Trust and his disallowance of deductions claimed with respect to that income.

We must next consider whether petitioners are liable for self-employment taxes attributable to the income reported by the Trust. Section 1401 provides for a tax on the self-employment income of every individual. "Self-employment income" is defined generally as "the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business." Secs. 1402(a); 1402(b). The amount of self-employment income subject to the tax is limited to \$14,100.00 in 1975, \$15,300.00 in 1976, \$16,500.00 in 1977, \$17,700.00 in 1978, and \$22,900.00 in 1979. Sec. 1402(b). Generally, "employees" are not subject to the imposition of the self-employment taxes.

Here, we have concluded that William had additional net income attributable to his osteopathic practice which in each year exceeded the limitation for self-employment taxes. William did not argue that he received this income as an employee. Consequently, we sustain respondent's determination as to the additional self-employment tax liability for each of the years at issue.

We must next consider whether petitioners are liable for the addition to the tax under section 6653(a) for each of the years at issue. Section 6653(a) provides for an addition to the tax if any part of any underpayment is due to negligence or intentional disregard of the rules and regulations. Respondent's

determination that a part of the underpayment for each year was due to negligence is presumptively correct. Maqill v. Commissioner, 70 T.C. 465, 479 (1978), affd. 651 F.2d 1233 (6th Cir. 1981). Petitioners "cannot avoid [their] duty to file accurate returns simply by shifting the responsibility to [their] agents." Enoch v. Commissioner, 57 T.C. 781, 802 (1972). Where tax avoidance is attempted through a family trust device at least one court has stated that "[n]o reasonable person would have trusted this scheme to work." Hanson v. Commissioner, supra at 1234.

Here, a certified public accountant prepared petitioners' 1975 and 1976 Federal income tax returns and the 1975 and 1976 Federal income tax returns of the Trust. The manner in which income and deductions were reported on these returns and the other returns filed by petitioners and the Trust resulted in deductions for petitioners' nondeductible personal expenditures for their residence and medical expenses on the Trust's Federal income tax returns. These amounts were not reported as income on petitioners' Federal income tax returns. In effect the manner in which the income and deductions were reported caused petitioners' income, in part, to "disappear." The record does not indicate whether the certified public accountant who prepared the 1975 and

1976 returns was aware of the underlying facts.⁷ However, William was an educated individual and was undoubtedly aware that he was not properly reporting his income and deductions in any of the years at issue. Consequently, we must sustain respondent's determination that petitioners are liable for the addition to tax under section 6653(a) for each of the years at issue.

We must next consider whether petitioners are liable for the addition to tax under section 6654(a). Section 6654 provides, in pertinent part:

(a) ADDITION TO THE TAX.--In the case of any underpayment of estimated tax by an individual, * * *, there shall be added to the tax under chapter 1 and the tax under chapter 2 for the taxable year an amount determined at an annual rate established under section 6621 [prior to July 1, 1975, the rate was six percent per annum] upon the amount of the underpayment (determined under subsection (b)) for the period of the underpayment (determined under subsection (c)).

(b) AMOUNT OF UNDERPAYMENT.--For purposes of subsection (a), the amount of the underpayment shall be the excess of--

(1) The amount of the installment which would be required to be paid if the estimated tax were equal to 80 percent * * * of the tax shown on the return for the taxable year, * * * over

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It is unclear whether Jay Q. Truxal, the certified public accountant who prepared the 1975 and 1976 Federal income tax returns, and Lelah M. Truxal, one of the original trustees of the Trust, were also petitioners in Truxal v. Commissioner, T. C. Memo. 1982-616, a case involving a similar trust arrangement to the one under consideration.

(2) The amount, if any, of the installment paid on or before the last date prescribed for such payment. [Emphasis added.]

"Tax shown on the return" does not mean the tax based on actual income for the year as ultimately determined, cf. Evans Cooperage Co., Inc. v. United States, 712 F.2d 199, 205 (5th Cir. 1983), (involving section 6655) and a similar interpretation is applicable to section 6654(b) which also uses "the tax shown on the return" as the basis for determining the installment due.⁸

Here, petitioners reported the following amounts as their tax liability for the years at issue:

<u>Year</u>	<u>Amount</u>
1975	\$632.06
1976	270.24
1977	-0-
1978	-0-
1979	-0-

Respondent determined additions to the tax under section 6654(a) for each of these years. However, it is clear that respondent did not properly compute the amount of the underpayment based on the "tax shown on the return for the taxable year."

Consequently, we do not sustain respondent's determination as to the amount of the addition to the tax under section 6654(a).⁹

Finally, we must consider whether damages should be awarded to the United States under section 6673. Section 6673 provides:

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See Rev. Rul. 83-36, 1983-1 C.B. 358.

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The computation of the amount of the addition to the tax under sec. 6654(a) shall be made pursuant to Rule 155.

Whenever it appears to the Tax Court that proceedings before it have been instituted or maintained by the taxpayer primarily for delay or that the taxpayer's position in such proceedings is frivolous or groundless, damages in an amount not in excess of \$5,000 shall be awarded to the United States by the Tax Court in its decision. Damages so awarded shall be assessed at the same time as the deficiency and shall be paid upon notice and demand from the Secretary and shall be collected as part of the tax.

Section 6673 is applicable to any action or proceeding pending in this Court on or after November 15, 1985. Sec. 160, Deficit Reduction Act of 1984, Pub. L. 98-369, 96 Stat. 696.

Here, we reluctantly conclude that it is not appropriate to award damages to the United States. While we believe that petitioners, in substantial part, did not intend to proceed with a meritorious action in this Court, we note that there was a jurisdictional issue for taxable years 1975 and 1976.¹⁰

To reflect the foregoing,

Decision will be entered
under Rule 155.

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Adjustments in petitioners' favor will not necessarily preclude an award of damages. See Piche v. Commissioner, T. C. Memo. 1986-29.

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T. C. Memo. 1986-232

UNITED STATES TAX COURT

PAUL ROBERT HARRIS, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 15246-85.

Filed June 9, 1986.

Paul Robert Harris, pro se.

Darrel Knudtson, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

PANUTHOS, Special Trial Judge: This case was assigned pursuant to section 7456(d)(3) and Rules 180, 181, and 182.¹

Respondent determined a deficiency in petitioner's 1982 Federal income tax in the amount of \$1,237.50.

¹ All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated, and all Rule references are to the Tax Court Rules of Practice and Procedure.

The issue for decision is whether petitioner can deduct contributions to an individual retirement account (IRA) which exceed \$2,250 for the taxable year 1982.² This case was submitted fully stipulated under Rule 122.

At the time of filing the petition herein, petitioner resided in Richmond, Virginia. Petitioner was employed during 1982 and received compensation in excess of \$4,500. Petitioner's wife Nancy was not employed during 1982. On February 15, 1983, petitioner deposited \$4,000 into an IRA in his name. On the same date petitioner deposited \$500 to an IRA in the name of his wife Nancy Harris.³

Petitioner filed a timely joint Federal income tax return for the taxable year 1982 with his wife. On the return petitioner claimed a deduction for contributions to an IRA in the amount of \$4,500.

In his notice of deficiency dated April 1, 1985, respondent disallowed \$2,250 of the \$4,500 contribution. Respondent's determination was based upon section 219(c)(2) which provides for a maximum allowable deduction to a combined IRA in the amount of \$2,250.

² In his notice of deficiency respondent determined an excise tax in the amount of \$135. Respondent conceded the excise tax adjustment in the stipulation of facts.

³ The parties stipulated that: "Petitioner has consistently maintained that the payments made to the IRA accounts were: \$2,250 attributable to tax year 1982 and \$2,250 attributable to tax year 1983." There is no evidence in the record that the payments were in fact made in that form. We need not make a finding on this question, however, in order to reach our conclusion herein.

Petitioner argues that subsections (a) and (c) of section 219 provide for limitations on the amount of deduction, but do not indicate the tax year in which a deduction can be taken. He further argues that the fact that a deduction is attributable to a given year does not mean that it cannot be taken in another tax year. Petitioner points to section 219(f)(3) and argues that the \$2,250 contribution, which was prior to the deadline for filing his 1982 return, can be deducted on his 1982 or 1983 return. He concludes that during the period starting with the close of the tax year and ending with the due date of the return⁴ a taxpayer may contribute the maximum amount (in this case \$2,250) both for the prior year (1982) and for the current year (1983), then deduct the entire amount (\$4,500) in the prior year's (1982) return.

Section 219(b) provides generally that the maximum amount that can be deducted for a qualified retirement contribution is the amount which does not exceed the lesser of \$2,000 or an amount equal to compensation includable in the individual's gross income for such taxable year. Section 219(c)(2) provides a further limitation in the case of married individuals. In the case of an individual who is otherwise entitled to a deduction under subsection (a) who files a joint return and whose spouse had no compensation for such taxable year the allowable deduction

⁴ In this case, the close of the first tax year to which petitioner alludes would be December 31, 1982 since petitioner is a calendar year, cash basis taxpayer. The due date of the return would be April 15, 1983.

cannot exceed the lesser of \$2,250 or the amount equal to the compensation includable in the individual's gross income.

Petitioner fits within the limitations of section 219(c)(2). The parties have stipulated that petitioner was married during the taxable year and filed a joint Federal income tax return. Petitioner further stipulated that his wife had no compensation for the year. Finally, the 1982 Federal income tax return reflects that the compensation includable in gross income exceeded \$2,250. Accordingly there is no question but the limitation of section 219(c)(2)(A)(i) applies. Thus petitioners' maximum contribution to an IRA would be \$2,250.

Section 219(f)(3)(A) allows a taxpayer to make contributions after the close of the tax year but prior to the time prescribed for filing a return. The legislative history of this section makes it clear that the purpose of this section was to extend the date by which an individual can make a deductible contribution to an IRA for a taxable year. See Anthes v. Commissioner, 81 T.C. 1, 3-4 (1983), affd. without published opinion 740 F.2d 953 (1st Cir. 1984); Cobb v. Commissioner, 77 T.C. 1096, 1099 n.3 (1981), affd. without published opinion 680 F.2d 1388 (5th Cir. 1982). We find nothing in the legislative history of this section which would indicate that a taxpayer may deduct amounts contributed in excess of \$2,250 for any taxable year. Pub.L. 95-600, 95 Stat.

2763. Based on the foregoing, petitioner is entitled to an IRA deduction for 1982 in the amount of \$2,250 and not \$4,500 as claimed.

Decision will be entered
for the respondent.⁵

⁵ The statutory notice of deficiency did not separately state the excise tax of \$135. Thus, the deficiency after respondent's concession of the excise tax is \$1,102.50.

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T. C. Memo. 1986-233

UNITED STATES TAX COURT

DONALD D. AND VERA H. BURK, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 10020-84.

Filed June 9, 1986.

Donald D. Burk, pro se.

Robert F. Cunningham, for the respondent.

MEMORANDUM OPINION

PAJAK, Special Trial Judge: This case was assigned pursuant
to section 7456 of the Code and Rule 180.¹

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All section references are to the Internal Revenue Code of 1954 as in effect during the taxable year in issue, unless otherwise indicated. All rule references are to the Tax Court Rules of Practice and Procedure.

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Respondent determined a deficiency in petitioners' 1980 Federal income tax in the amount of \$1,976. The only issue for decision is whether petitioners are entitled to a residential energy credit under section 44C.

To the extent stipulated, the relevant facts are so found.² Petitioners resided in Eau Claire, Wisconsin, at the time they filed their petition.

In 1979, petitioners began the construction of a new residence. Petitioners wished to heat the residence with a heating system that would conserve energy and also would qualify for an energy tax credit. When petitioners made the decision sometime in 1979 to install the heating system, they were advised by Internal Revenue Service representatives that the expenditures for the system would qualify for such a credit.

The heating system installed by petitioners extracts heat from ground water by means of a heat pump. The water used in the system is drawn from a well 190 feet deep. The system pumps ground water into the house and circulates the water through a bimetal coil. Freon coils around the bimetal coil are used to extract the natural warmth from the water. This apparatus is called a heat pump extractor. A forced air fan then circulates the heat through the home. Although the exact temperature of the

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Respondent has objected to paragraph 10 of the stipulation of facts on the grounds that the statements contained there are not relevant to the proceedings. We agree. Accordingly, we do not find as fact any of the statements contained in that paragraph.

ground water is not known, petitioners concede that it is less than 50 degrees Celsius (122 degrees Fahrenheit) at the wellhead. Based on petitioner Donald D. Burk's testimony, we find that it was about 14 degrees Celsius at the wellhead.

On their joint 1980 Federal income tax return, petitioners claimed a geothermal energy credit in the amount of \$1,976. Respondent disallowed this credit because the water used in petitioners' heating system did not qualify as a geothermal deposit.

Section 44C [now section 23] provides that an individual taxpayer will be allowed a credit against tax for "qualified renewable energy source expenditures." These expenditures must be made with respect to renewable energy source property. Section 44C(c)(2)(A). Renewable energy source property includes property which, when installed in connection with a dwelling, transmits or uses energy derived from geothermal deposits. Section 44C(c)(5)(A)(i).

Under section 44C(c)(6)(A)(i), the Secretary is authorized to issue regulations which establish specific criteria to be used in prescribing performance and quality standards for renewable energy source property. The Secretary has issued section 1.44C-2(h), Income Tax Regs., which provides in pertinent part that:

The term "geothermal energy property" includes equipment * * * necessary to transmit or use energy from a geothermal deposit to heat or cool a dwelling * * *. A geothermal deposit is a geothermal reservoir consisting of natural heat which is from an underground source and is stored in rocks or in an aqueous liquid or vapor (whether or not under pressure), having a temperature exceeding 50

degrees Celsius as measured at the wellhead or, in the case of a natural hot spring (where no well is drilled), at the intake to the distribution system. [Emphasis added.]

Petitioners' heating system does not qualify as geothermal property under the regulations because it does not use water which has a temperature exceeding 50 degrees Celsius at the wellhead.

Petitioners first contend that the 50 degrees requirement, as set forth in the regulation, is contrary to the intent of Congress in enacting section 44C. Since the regulation in question here was not in effect in 1979 when they made their decision to install the heating system, they also argue that it is arbitrary and unreasonable for respondent to apply his regulations retroactively.³ Lastly, they claim they were advised by respondent's agents that they would be entitled to the credit.

With respect to petitioners' first argument, this Court has upheld the validity of section 1.44C-2(h), Income Tax Reg. under facts similar to those present here. Peach v. Commissioner, 84 T.C. 1312 (1985). See Hickey v. Commissioner, T.C. Memo. 1986-186; Bayless v. Commissioner, T.C. Memo. 1986-113; Rabenold v. Commissioner, T.C. Memo. 1985-309, on appeal (11th Cir., Sept. 23, 1985); Reddy v. Commissioner, T.C. Memo. 1984-395, affd. per

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Proposed regulations setting forth a 60 degrees Celsius requirement were published by the Secretary in the Federal Register (44 Fed. Reg. 29923 (1979)) on May 23, 1979. Section 1.44C-2(h), Income Tax Regs., setting forth the 50 degrees requirement was published on Aug. 29, 1980 (45 Fed. Reg. 57712 (1980)).

order (4th Cir., August 29, 1985). In Peach v. Commissioner, supra, the Court explained that this regulation was promulgated pursuant to a specific legislative authority and since it is legislative in nature, it should be sustained unless clearly inconsistent with the statute. The Court held that: "a requirement of a temperature exceeding 50 degrees Celsius is a reasonable regulation for determining the heat requirement of a geothermal deposit." (Fn. ref. omitted.) Peach v. Commissioner, supra at 1317.

Petitioners' second argument also has been considered and rejected by this Court. In Peach v. Commissioner, supra, the Court observed that under section 7805(b) respondent may apply regulations retroactively unless otherwise specified. The Court further noted that "except in unusual circumstances, making a regulation retroactive is not an abuse of discretion by the Commissioner." Peach v. Commissioner, supra at 1318.

Lastly, whatever Internal Revenue Service representatives may have advised petitioners, it is well established that the Commissioner is not bound by an erroneous interpretation of law by his agents but must follow the statutes, regulations and case law. Dixon v. United States, 381 U.S. 68, 72-73 (1965); Neri v. Commissioner, 54 T.C. 767 (1970).

Although petitioners' attempt to conserve energy and thus benefit the nation by reducing its dependency on imported fuel supplies is commendable, they are not entitled to a residential

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energy credit in 1980 under section 44C and section 1.44C-2(h),
Income Tax Regs. Accordingly, respondent's determination is
sustained.

Decision will be entered
for the respondent.

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T. C. Memo. 1986-234

ORIGINAL

UNITED STATES TAX COURT

CAROLYN A. AND OAKLEY B. HILL, Petitioners, v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 39777-84.

Filed June 9, 1986.

Oakley B. Hill, pro se.

Howard P. Levine, for the respondent.

MEMORANDUM OPINION

GUSSIS, Special Trial Judge: This case was assigned to Special Trial Judge James M. Gussis pursuant to section 7456(d)(3) of the Internal Revenue Code of 1954 and Rules 180, 181, and 182 of the Tax Court Rules of Practice and Procedure.¹

Respondent determined a deficiency in petitioners' Federal income tax for 1981 in the amount of \$2,229. Petitioners have conceded the interest expense adjustment. The remaining issue is

¹ All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated. Rule references are to the Tax Court Rules of Practice and Procedure.

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whether petitioners are entitled to a deduction in 1981 under section 162(a) for automobile expenses (based on mileage) in the amount of \$3,796.40.

Petitioners were residents of Crossville, Tennessee at the time the petition herein was filed. Petitioner Oakley B. Hill, a steamfitter, was employed by the Tennessee Valley Authority at the Watts Bar Nuclear Plant from May 1, 1972 to January 14, 1977 with periodic interruptions of work. He was again employed at the Watts Bar Nuclear Plant on August 4, 1980 and remained on the job at the plant until June 1985 when he retired after his second heart attack.² Petitioner claimed a deduction in 1981 for automobile expenses (based on mileage) in the amount of \$3,796.40 incurred in traveling to the job site at the Watts Bar Nuclear Plant. Respondent disallowed the deduction.

Generally, the expenditures incurred by a taxpayer for daily commuting are nondeductible personal expenses. Section 262. However, under an exception to this rule, a taxpayer may deduct transportation expenses associated with employment which is temporary (rather than indefinite) in duration. Peurifoy v. Commissioner, 358 U.S. 59 (1958). Employment is temporary if it is expected to terminate within a relatively short period of time and such termination is foreseeable. Stricker v. Commissioner, 54 T.C. 355 (1970), affd. 438 F.2d 1216 (6th Cir. 1971). The determination of whether a job is temporary or indefinite in

² Petitioner's first heart attack occurred in 1982.

nature is a factual question. Kasun v. United States, 671 F.2d 1059, 1061 (7th Cir. 1982). Petitioner has the burden of proof. Rule 142(a).

It fairly appears on this record that petitioner's employment at the Watts Bar Nuclear Plant in 1981 was not temporary but, instead, was indefinite. He remained on the job nearly five years after he returned to the Watts Bar Nuclear Plant in August 1980 and left his job in June 1985 because of health problems. There was a considerable work force engaged on the project in 1981 and it was anticipated by management that the demand for skilled workers in petitioner's craft would continue for a considerable period of time. There were no factors present in 1981 that would support a reasonable inference of short-term employment at the Watts Bar Nuclear Plant. We find no merit in petitioner's argument that 1980 and 1981 was a "probation period more or less" because, in the event of a lay-off, employees with less than a year of employment would be the first to go. In view of the evident demand for steamfitters at this particular time it was unlikely that general dismissals for members in that craft would be initiated. In any event, it is clear that petitioner's argument underscores the impermanence of his job during the first year (i.e., the so-called "probationary period"). However, the impermanence of a job does not by itself make the job a temporary one. Kennedy v. Commissioner, 451 F.2d 1023 (3d Cir. 1971), affg. per curiam a Memorandum Opinion of this Court; Garlock v.

Commissioner, 34 T.C. 611, 616 (1960). We must conclude on this record that petitioner's employment at the Watts Bar Nuclear Plant site in 1981 was not temporary and, therefore, petitioner is not entitled to deduct his transportation expenses incurred with respect to his employment at the project. Respondent is sustained.

Decision will be entered
for the respondent.

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T. C. Memo. 1986-235

UNITED STATES TAX COURT

CHARLES PATRICK AND TONJA MICHELLE FLIPPEN, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 13731-85.

Filed June 9, 1986.

Charles Patrick Flippen, pro se.

Howard P. Levine, for the respondent.

MEMORANDUM OPINION

GUSSIS, Special Trial Judge: This case was assigned to Special Trial Judge James M. Gussis pursuant to section 7456(d)(3) of the Internal Revenue Code of 1954 and Rules 180, 181 and 182 of the Tax Court Rules of Practice and Procedure.¹

Respondent determined deficiencies in petitioners' Federal income taxes for the years 1981 and 1982 in the amounts of \$1,261 and \$1,277, respectively. The issue is whether petitioners are

¹ All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated. Rule references are to the Tax Court Rules of Practice and Procedure.

entitled to a deduction under section 162(a) for certain automobile expenses (based on mileage) incurred in the years 1981 and 1982.

The stipulated facts are incorporated herein by this reference. Petitioners were residents of Chattanooga, Tennessee at the time the petition herein was filed.

Petitioner Charles P. Flippen was employed by the Tennessee Valley Authority (TVA) as an apprentice steamfitter at the Sequoia Nuclear Plant in the vicinity of Chattanooga, Tennessee from February 20, 1979 to May 29, 1981. In order to become a journeyman under the TVA-sponsored apprenticeship program, petitioner was required to complete 8,000 hours of on-the-job training and 576 hours of related classroom training. On May 28, 1981 petitioner voluntarily resigned from his position at the Sequoia Nuclear Plant in order to accept employment with the Tennessee Valley Authority at the Watts Bar Nuclear Plant near Spring City, Tennessee. Petitioner was then employed by the Tennessee Valley Authority at the Watts Bar Nuclear Plant from June 2, 1981 through February 14, 1984. Petitioner completed his steamfitter apprenticeship at the Watts Bar Nuclear Plant on November 19, 1982 and thereafter assumed the duties of a steamfitter-welder at the plant. On February 14, 1984 petitioner voluntarily resigned from his job at the Watts Bar Nuclear Plant after receiving official notification of a contemplated reduction

in force at the plant and on February 21, 1984 he was reemployed by the Tennessee Valley Authority at the Sequoia Nuclear Plant as a steamfitter-welder.

Petitioner claimed deductions for automobile expenses (based on mileage) incurred in traveling to the Watts Bar Nuclear Plant job site in 1981 and 1982 in the respective amounts of \$3,263 and \$4,629 which were disallowed by respondent. Expenditures for daily commuting are generally nondeductible personal expenses. Section 262. An exception to this rule allows a taxpayer to deduct transportation expenses associated with employment which is temporary (rather than indefinite) in duration. Peurifoy v. Commissioner, 358 U.S. 59 (1958). Employment is temporary if it is expected to terminate within a relatively short period of time and such termination is foreseeable. Stricker v. Commissioner, 54 T.C. 355 (1970), affd. 438 F.2d 1216 (6th Cir. 1971). The determination of whether a job is temporary or indefinite in nature is a factual question. Kasun v. United States, 671 F.2d 1059, 1061 (7th Cir. 1982). Petitioner has the burden of proof. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).

Here, petitioner worked at the Watts Bar Nuclear Plant job site from June 2, 1981 through February 14, 1984. In 1981 the construction work at the job site had reached a stage requiring a steady need for steamfitters. We cannot agree with petitioner's argument that his job at the Watts Bar Nuclear Plant site was temporary because he only had some 3,000 hours left to complete

his apprenticeship training when he started his employment there in June 1981. The record shows that upon completion of his apprenticeship training he simply assumed the status and duties of a steamfitter-welder and continued his employment until February 1984. His continued employment at the project was not geared to the apprenticeship program. Petitioner's testimony that he was aware of past instances where no vacancies were available to apprentices upon completion of their training program merely underscores the inherent uncertainties of employment in the construction field. It clearly appears on this record that petitioner did not know how long his job would last. Impermanence by itself does not make the job a temporary one. Kennedy v. Commissioner, 451 F.2d 1023 (3d Cir. 1971), affg. per curiam a Memorandum Opinion of this Court. We must conclude on this record that petitioner's employment at the Watts Bar Nuclear Plant in 1981 and 1982 was not temporary and, therefore; petitioner is not entitled to deduct his transportation expenses incurred with respect to his employment at the project.² Respondent is sustained.

Decision will be entered
for the respondent.

² We have considered the case of Norwood v. Commissioner, 66 T.C. 467 (1976), which petitioner has called to our attention, and we believe that said case is factually distinguishable.

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UNITED STATES TAX COURT

AL G. HUSHER, Petitioner v. COMMISSIONER OF INTERNAL REVENUE,
Respondent

Docket Nos. 3575-82, 13962-84.

Filed June 9, 1986.

Al G. Husher, pro se.

David Goldberg, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

WRIGHT, Judge: By notice of deficiency, respondent determined deficiencies and additions to petitioner's Federal income tax as follows:

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Year	Deficiency	Additions to Tax			
		<u>Sec. 6651(a)(1)¹</u>	<u>Sec. 6653(a)(1)</u>	<u>Sec. 6653(a)(2)</u>	<u>Sec. 6654(a)</u>
1980	\$4,860.40	\$ 891.39	\$243.02	-	-
1981	7,164.00	1,633.01	358.20	50% of the interest due on \$7,164.00	\$488.43

In his Amendment to Answer respondent asserted the following increased deficiency and additions to tax²:

Year	Deficiency	Additions to Tax	
		<u>Sec. 6651(a)(1)</u>	<u>Sec. 6653(a)(1)</u>
1980	\$6,199.67	\$1,226.20	\$309.98

The issues for decision are (1) whether petitioner is liable for income tax on wages received during 1980 and 1981, (2) whether petitioner's filing status for 1980 is married filing separately, (3) whether petitioner is liable for additions to tax under sections 6651(a)(1) and 6653(a)(1) for 1980 and 1981 and sections 6653(a)(2) and 6654(a) for 1981, and (4) whether petitioner is liable for damages under section 6673.

¹ All section references are to the Internal Revenue Code of 1954, as amended and in effect during the years at issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

² The increases in the additions to tax are due to the increased deficiency amount.

FINDINGS OF FACT

Petitioner Al G. Husher resided in Cambria Heights, New York, when the petitions herein were filed. Petitioner had properly filed Federal income tax returns for taxable years prior to 1980. Throughout 1980 petitioner was married to Darlene Husher.

Petitioner was employed by the New York City Transit Authority as a tower operator during the years in issue and earned wages totaling \$23,010.84 and \$24,005.80 during 1980 and 1981, respectively. No contracts were entered into during those years between the New York City Transit Authority and any churches on behalf of petitioner.

Petitioner filed a Form 1040 for taxable year 1980, which purported to be his Federal income tax return. On this form petitioner stated that his occupation was that of minister; he indicated no filing status. Although the Form W-2 attached to petitioner's Form 1040 showed that petitioner had wages, tips, and other compensation of \$23,010.84, petitioner left blank the lines provided for information concerning income, adjustments, credits, and tax and claimed a refund of \$1,294.86, the amount of Federal income tax that had been withheld. Below his signature petitioner entered the following statement: "I have taken an

irrevocable vow of poverty (copy attached) and have received a directive from the head of my order and am therfor [sic] exempt from Federal income tax 1040."

For 1981, petitioner again filed a Form 1040, which purported to be his Federal income tax return. On this form, petitioner stated that his occupation was that of minister and he indicated that he was married filing a separate return. The Form W-2 attached to the Form 1040 showed that petitioner had wages, tips, and other compensation of \$24,005.80. Petitioner, however, left blank the lines provided for information concerning income, adjustments, credits, and tax and claimed a refund of \$631.98, the amount of Federal income tax that had been withheld. Attached to the Form 1040 was a slip of paper on which was typed the following statement: "Reverend A. G. Husher is a member of a Religious Order who has taken an irrevocable Vow of Poverty and performs services pursuant to direction by the Order as an agent. The income generated is the property of the Church and Order and not personal income to the individual." Petitioner's name was handwritten in ink on the line provided for that purpose. This statement also listed an address to write to for "confirmation or clarification."

The Forms 1040 filed by petitioner for 1980 and 1981 did not constitute Federal income tax returns. In his notice of deficiency for 1980, respondent determined that petitioner had received income during that year of \$23,010 and computed

petitioner's tax liability based on the tax rate for unmarried individuals. In addition, respondent determined additions to tax under sections 6651(a) and 6653(a). By Amendment to Answer respondent alleged that petitioner was married as of December 31, 1980, and, accordingly, recalculated petitioner's tax liability based on the tax rates for married individuals filing separate returns, resulting in increases in the amounts of deficiency and additions to tax for 1980. In his notice of deficiency for 1981, respondent determined that petitioner had received income during that year of \$24,005 and further determined additions to tax under sections 6651(a)(1), 6653(a)(1), 6653(a)(2), and 6654(a).

OPINION

As a preliminary matter, we note that the determinations made by respondent in his notice of deficiency are presumed correct and petitioner has the burden of proving otherwise. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a). With respect to the increased deficiency and additions to tax raised in the Amendment to Answer, however, respondent has the burden of proof. Rule 142(a).

The first issue is whether petitioner is liable for income tax on the wages received by him during 1980 and 1981 as an employee of the New York City Transit Authority. In the Forms 1040 filed with respondent for those years petitioner contends that he has taken a vow of poverty and is therefore exempt from

Federal income tax. Except as otherwise provided by law, gross income includes all income from whatever source derived. Sec. 61. Section 61(a) specifically includes compensation for services as an income item. Income earned by an individual on his own behalf is taxable to that individual, regardless of an alleged vow of poverty made by the individual. McGahen v. Commissioner, 76 T.C. 468 (1981), affd. without published opinion 720 F.2d 664 (3d Cir. 1983). The record in this case shows that the wages paid to petitioner were for petitioner's services as a tower operator for the Transit Authority. The wages received by petitioner were not received on behalf of a separate and distinct principal, but were received by petitioner in his individual capacity. Accordingly, we find that petitioner is not exempt from Federal income tax.

At trial petitioner argued that the wages received were in equal exchange for his labor and, therefore, he had no income. This argument has been considered and rejected by this and other courts (Eisner v. Macomber, 252 U.S. 189 (1920); Abrams v. Commissioner, 82 T.C. 403 (1984), and cases cited therein; Rowlee v. Commissioner, 80 T.C. 1111 (1983)), and must be considered meritless. Gross income includes income realized in any form, whether in money, property, or services. Sec. 61(a); Sec. 1.61-1(a), Income Tax Regs. Income includes "gain derived from capital, labor, or from both combined". Eisner v. Macomber, supra at 207. Thus, the compensation received by petitioner in

the form of wages is taxable as income. Abrams v. Commissioner, supra at 407. Accordingly, we sustain respondent's determination that petitioner's wages in the years at issue constitute taxable income.

The next issue is whether petitioner's tax liability for 1980 should be computed using the rates applicable to individuals who are married filing separately. Respondent has the burden of proof as to this issue. Rule 142(a). Petitioner did not indicate any filing status on the Form 1040 filed with respondent for 1980. Petitioner and his spouse did not elect to file a joint return for 1980. Furthermore, as discussed in this opinion, petitioner failed to file any tax return for that year. Petitioner admitted at trial that he was married throughout 1980. Based on these facts, the only filing status available to petitioner for his 1980 taxable year is married filing separately. Thompson v. Commissioner, 78 T.C. 558 (1982).³

The next issue is whether petitioner is liable for additions to tax under sections 6651(a)(1), 6653(a)(1), 6653(a)(2), and 6654(a).

³ Where, however, no return has been filed prior to a return on which joint return status is claimed, the limitations of section 6013(b)(2) are inapplicable. Phillips v. Commissioner, 86 T.C. ____ (filed Mar. 24, 1986).

Section 6651(a)(1) imposes an addition to tax for failure to file a timely return, unless it is shown that such failure is due to reasonable cause and not due to willful neglect. In order to constitute a return, a document need not be perfectly accurate or complete as long as it is sworn to as such, and evinces an honest and genuine endeavor to satisfy the requirements for a return. Jarvis v. Commissioner, 78 T.C. 646 (1982), and cases cited therein; Reiff v. Commissioner, 77 T.C. 1169, 1177 (1981); United States v. Moore, 627 F.2d 830, 834-835 (7th Cir. 1980). Further, it must contain sufficient information from which respondent can compute and assess the tax liability of a particular taxpayer. Reiff v. Commissioner, supra, and cases cited therein. A Form 1040 which fails to contain this data does not constitute a "return." Thompson v. Commissioner, supra at 561-562; United States v. Porth, 426 F.2d 519 (10th Cir. 1970).

The Forms 1040 submitted to respondent for 1980 and 1981 disclose virtually no information with respect to petitioner's income and supply no information with respect to the computation of petitioner's tax liability. Accordingly, we find that these Forms 1040 do not contain sufficient information from which petitioner's income tax liability for 1980 and 1981 can be computed, and they do not represent an honest and reasonable attempt to satisfy the requirements of the tax law. Therefore, we conclude that such Forms 1040 do not constitute "returns". Petitioner introduced no evidence to show reasonable cause for

his failure to file proper returns for the years here in issue. Accordingly, we sustain respondent's determinations with respect to the additions to tax for 1980 and 1981, under section 6651(a)(1) for failure to file timely returns. Hatfield v. Commissioner, 68 T.C. 895, 898 (1977).

Section 6653(a)(1) provides for an addition to tax if any part of any underpayment is due to negligence or intentional disregard of rules and regulations. Section 6653(a)(2) provides for an addition to tax in an amount equal to 50 percent of the interest payable under section 6601 with respect to the portion of underpayment that is attributable to negligence or intentional disregard of rules and regulations and for the period beginning on the last date prescribed by law for payment. For the tax years prior to 1980, petitioner demonstrated knowledge of his duty to file a return and of the proper reporting of income. As discussed herein, petitioner failed to file a return for 1980 and for 1981. It is clear from the record that petitioner's underpayment was attributable to "negligence or intentional disregard of rules and regulations." McGahen v. Commissioner, supra at 484. Petitioner, who bears the burden of proving that his underpayment was not due to negligence or intentional disregard of rules and regulations (Rule 142(a); Rixby v. Commissioner, 58 T.C. 757 (1972)), introduced no evidence on this issue. Accordingly, we sustain respondent's determination with respect to the additions to tax under section 6653(a)(1). We

also conclude, for purposes of the addition to tax under section 6653(a)(2), that all of petitioner's underpayment for 1981 was attributable to negligence or intentional disregard of rules and regulations.

Section 6654 imposes an addition to tax for underpayment of estimated tax. Where there has been a failure to pay or an underpayment of estimated tax, this addition is mandatory and no inquiry is made as to reasonable cause or lack of willful neglect. Bagur v. Commissioner, 66 T.C. 817, 824 (1976). Petitioner introduced no evidence indicating that respondent erred in determining that an addition to tax should be imposed under this section. Accordingly, we sustain respondent's determination. Habersham-Bey v. Commissioner, 78 T.C. 304, 319-320 (1982).

Finally, we must consider whether petitioner is liable for damages pursuant to section 6673. Section 6673 provides that the Court may award damages to the United States of up to \$5,000 whenever it appears that the proceedings have been instituted or maintained primarily for delay or that the taxpayer's position is frivolous or groundless. The arguments presented by petitioner in this case have been rejected by the courts repeatedly. Thus, we conclude that petitioner's position is frivolous or groundless and that these proceedings were instituted or maintained primarily for delay. Abrams v. Commissioner, 82 T.C. 403, 408-

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413 (1984). We therefore award damages to the United States in the amount of \$3,000 in docket No. 3575-82 and \$5,000 in docket No. 13962-84.

To reflect the foregoing,

Decisions will be entered
for the respondent.

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T. C. Memo. 1986-237

UNITED STATES TAX COURT

THOMAS FRED WARD, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 19536-83.

Filed June 10, 1986.

W. Rodney DeVilliers, for the petitioner.

David G. Hendricks, for the respondent.

WILLIAMS, Judge: The Commissioner determined deficiencies in petitioner's Federal income tax and additions to tax pursuant to section 6653(b)¹ for the taxable years 1977, 1978 and 1979 as follows:

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All section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue, unless otherwise indicated.

<u>Year</u>	<u>Deficiency</u>	<u>Additions to Tax</u>
1977	\$32,127.97	\$16,063.99
1978	74,894.08	37,447.04
1979	85,283.59	42,641.80

The Court must decide the following two issues: (1) whether petitioner failed to report income for the taxable years 1977, 1978 and 1979; and (2) whether any part of any underpayment of tax for the taxable years 1977, 1978 and 1979 is due to fraud with intent to evade Federal income tax within the meaning of section 6653(b).

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. Petitioner, Thomas F. Ward, resided in Lawton, Oklahoma at the time his petition was filed.

Petitioner filed Federal income tax returns for each of the years 1977, 1978 and 1979 using the cash method of accounting. On his return for 1977 petitioner reported gross income of \$7,200, representing "money made from poker games at my house." For 1978 petitioner reported gross income of \$12,500, \$5,700 of which was from "operating a poker game" and \$6,800 of which was from "playing cards and shooting dice." For 1979 petitioner reported gross income of \$13,649, \$1,349 of which represented earnings from transactions in the gold market. Petitioner took

no deductions for interest, taxes or other expenses for any of the years at issue in this case. His principal occupation for the past 32 years has been gambling, primarily bookmaking.

Petitioner married Netta Ward (Netta) in 1937, and he divorced her in 1956. Pursuant to the divorce petitioner and Netta agreed upon a property settlement under which Netta received, among other things, the real property acquired by petitioner and Netta during their marriage, including the property known as 1 Morford Drive, Lawton, Oklahoma. In 1962 petitioner remarried Netta, and he divorced her again in 1967. The second divorce decree states that no property was jointly owned at the time of the second divorce.

Petitioner has had exclusive control over Netta's financial affairs since their second divorce, though Netta was competent to handle her own affairs until 1979 or 1980. Petitioner made deposits to a bank account in Netta's name at various times during each of the years 1977, 1978 and 1979 of the following amounts:

<u>Year</u>	<u>Amount</u>
1977	\$ 4,900.00
1978	7,950.00
1979	10,200.00

Petitioner maintained no records of the expenses incurred for taxes, upkeep and other costs associated with the maintenance of properties held in Netta's name.² He did not file tax returns for Netta. Petitioner was not accountable to any other individual for his purported management of Netta's financial affairs and did not act in the manner of a fiduciary.

The property at 1 Morford Drive, owned by Netta pursuant to the divorce decree of 1957, was sold in 1979 for \$70,000. Netta endorsed the proceeds of this sale to petitioner, who used the funds to purchase a series of cashier's checks. These checks were applied by petitioner for his own benefit in the following manner:

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Petitioner alleges that the records he did keep with respect to the properties held in Netta's name were stolen in 1983. Other than his conclusory testimony, petitioner presented no evidence of the theft and could not describe either the books he supposedly kept or his method of tracking costs, expenses or income.

<u>Cashier's Check #</u>	<u>Amount</u>	<u>Disposition</u>
88157	\$ 9,000.00	Cashed
88158	8,000.00	Cashed
88159	6,000.00	Investment in Soundstage ³
88160	9,000.00	Soundstage
88161	8,000.00	Soundstage
88162	8,000.00	Soundstage
88164	4,000.00	Soundstage
88163	5,000.00	Endorsed to Hilton Casino, Las Vegas
88165	8,295.43	Cashed
88166	1,869.11	Paid to IRS for petitioner
88167	<u>2,835.46</u>	Paid to IRS for petitioner
Total: \$70,000.00		

Prior to 1974 respondent had assessed \$331,873.70 in wagering excise taxes for petitioner's taxable years 1971 and 1972. In May of 1974 respondent regarded these taxes as uncollectible. Petitioner was subsequently convicted in June of 1983 of concealing money, property and interests with intent to evade and defeat the collection of the wagering excise taxes respondent had assessed against him. The conviction was upheld by the Court of Appeals for the Tenth Circuit.

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Soundstage was a club in Lawton, Oklahoma in which petitioner owned a one-half interest.

Petitioner as buyer and the American Company as seller executed in 1975 a contract for the sale of 105 acres of land identified as lying north of Highway 62 near Cache, Oklahoma (the "105-acre tract") for \$52,000. The terms of purchase of the 105-acre tract called for a down payment of \$12,000 and equal annual payments of \$10,000 per year for four years. Petitioner did not receive a deed for the 105-acre tract from the American Company. Petitioner and the American Company agreed not to record their contract for the sale of the 105-acre tract to evade Federal tax liens that attached to petitioner's property.

In 1975 petitioner also purchased from the American Company a 355-acre ranch identified as lying south of Highway 62 near Cache, Oklahoma (the "Cache ranch") for \$175,000. Petitioner claims that the Cache ranch belonged to Netta. Netta resided at the Cache ranch following the sale of 1 Morford Drive. The terms of purchase for the Cache ranch called for a down payment of \$35,000 and equal annual payments of \$35,000 per year for four years.

In February of 1977 petitioner deposited \$45,000 to an account at the American National Bank, the parent of the American Company. This payment was an installment payment on petitioner's purchase of the two tracts.

Petitioner platted the 105-acre tract into 10-acre parcels, one of which was purchased by James Brown in 1979 for \$13,500. The real estate agent involved in the transaction, Opher Cephas,

received a deed to the 10-acre parcel from the American Company to petitioner, whereupon he prepared a deed to the parcel from petitioner to Brown. Both deeds were recorded by Cephas. The check for the purchase price of the 10-acre parcel was made payable to petitioner and the American Company and was endorsed by both parties. However, since record title to the parcel passed from the American Company to petitioner and thence from petitioner to Brown, Federal wagering excise tax liens against petitioner attached to the 10-acre parcel. These liens were later released as a result of the expiration of the applicable statute of limitations.

Petitioner also received funds in installments from Carol Biggs during 1978 for the purchase of a 10-acre parcel on the 105-acre tract. Petitioner admitted that the funds received from this sale were his. A check for \$12,842.79 dated February 8, 1979 to petitioner and to the American Company, and endorsed by both parties, was for another 10-acre parcel on this same 105-acre tract. We find these funds to have been petitioner's.

Petitioner owned a one-half interest in a 480-acre farm near Snyder, Oklahoma, from which he received income from the sale of cotton, wheat and cattle. In 1978 petitioner received net income of \$4,533.00 from the sale of cotton. In 1979 petitioner received \$2,562.50 in net income from the sale of cattle and \$6,598.25 in net income from the sale of wheat.

Petitioner also received net income from the sale of cattle which were kept on the Cache ranch in the amounts of \$1,327.47 in September of 1978 and of \$15,522.85 in September of 1979.⁴

Petitioner purchased several properties during the years at issue in this case through an arrangement with Peggy McDaniels. Petitioner provided McDaniels with the capital necessary to purchase a given property; McDaniels would resell the property, and the two would evenly divide the profits generated thereby. In this manner, petitioner provided McDaniels with \$1,500 in cash in April of 1977 with which she purchased property in Elgin, Oklahoma. The deed to the property was not recorded for the purpose of evading federal tax liens. Petitioner also provided McDaniels with \$9,000 in cash for the purchase of property identified as 2409 H Street in Lawton, Oklahoma, and with \$4,000 in cash for the purchase of property identified as 2104 Bessie Street in Lawton, Oklahoma. Both of these transactions occurred in 1979.

During the years 1977, 1978 and 1979 Ray Caldwell was employed by petitioner to manage the rental properties which petitioner alleges were owned by Netta. Petitioner received rental payments from various properties, which included mobile homes, duplexes and houses. Caldwell remitted to petitioner all

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Petitioner asserts that the cattle belonged to Netta. Clyde Ward, petitioner's brother, stated that he sold "Tom [petitioner] and Mrs. Ward's cattle," and that he endorsed the proceeds from the sales over to petitioner. We find that the cattle belonged to petitioner.

rental payments he collected, after deducting his wages and the expenses he incurred in maintaining the properties. Caldwell and Caldwell's parents each rented property from petitioner and their payments were included in Caldwell's remittances to petitioner. Petitioner received between \$600 and \$1,000 per month in rental income collected by Caldwell.⁵

Petitioner owned a property known as the Little Giant store, which he sold to Peggy McDaniels in 1978 for approximately \$35,000. McDaniels paid petitioner in installments of \$500 per month until the store was destroyed by fire.⁶

Petitioner also owned a property known as the Big Giant store, which he sold to Odell Breeze in 1976 for \$25,000. Breeze paid petitioner in installments of \$505.95 per month during each of the years 1977, 1978 and 1979. Petitioner did not elect pursuant to section 453 to report his income from the

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Petitioner also received three checks during the year 1978 from Cruz Ramirez in the amount of \$100.00, \$89.92 and \$100.00, respectively. On the checks are statements that they are payments for rent. Petitioner claims they were to pay gambling debts. Whether for rent or for payment of money lost to petitioner in gambling, the amounts are income to petitioner in 1978.

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The record shows the last payment to be a check from McDaniels to petitioner for \$500 dated May 28, 1979.

sales of the Big Giant and Little Giant stores on the installment basis. Petitioner's basis in these properties cannot be determined from the evidence presented.

Petitioner submitted a financial statement to the Sheridan Bank and Trust Company of Tulsa, Oklahoma in 1976 indicating a personal net worth of \$632,500. A similar statement in the names of petitioner and Netta submitted in 1979 indicates a net worth of \$1,235,500. Petitioner's business is listed on the statements as "rancher and investments."

In February of 1979 petitioner obtained a \$175,000 loan from the Sheridan Bank and Trust Company. The note was secured by a mortgage on the Cache ranch. Both petitioner and Netta signed the note, the proceeds of which were applied in the following manner:

<u>Amount</u>	<u>Disposition</u>
\$ 4,147.50	Payment on loan in the name of Tom F. Ward
20,852.50	Payment on loan in the name of Tom Ward
25,039.50	Payment on loan in the name of Tom F. Ward
50,000.00	Used to purchase participation certificate in third party's loan
25,000.00	Purchase cashier's check #84856 payable to Bob Ensley as a loan
960.50	Purchase cashier's check #84857 payable to Tom Ward, cashed 4-20-79
9,000.00	Purchase cashier's check #84858 payable to Tom Ward, cashed 4-11-79
<u>40,000.00</u>	Purchase cashier's check #84859 payable to Tom Ward, cashed 5-8-79
Total	\$175,000.00

For the taxable years 1977, 1978 and 1979, respondent contends that the sources of funds received by petitioner and the applications of funds made by petitioner were as follows:

	<u>1977</u>	<u>1978</u>	<u>1979</u>
Sources - Total	\$ 68,578.55	\$ 75,738.66	\$508,828.59
- Nontaxable	60,423.11	35,144.00	386,280.93
Applications - Total	183,689.13	147,949.18	505,631.37
- Deductible	10,917.88	7,940.72	10,238.02

Using the sources and expenditures method of calculation of income, respondent contends that petitioner's gross income and deductions are as follows:

	<u>1977</u>	<u>1978</u>	<u>1979</u>
Application of Funds	\$183,689.13	\$147,949.18	\$505,631.37
Less Nontaxable Sources	60,423.11	35,144.00	386,280.93
Less Basis in Realty Sales per Notice of Deficiency	--	--	51,600.00
Less §1202 Deduction per Notice of Deficiency	--	--	31,645.63
Adjusted Gross Income	123,266.02	112,805.18	36,105.44
Less Taxes Expense	1,863.81	2,378.08	4,436.36
Less Interest Expense	9,054.07	5,562.64	5,801.66
Less Dividend Exclusion	--	81.36	--
Net Income as Adjusted	112,348.14	104,864.46	25,867.42
Net Income Reported	7,200.00	12,500.00	13,649.00
Omitted Income	105,148.14	92,364.46	12,218.42

OPINION

Petitioner argues that certain amounts attributed to him by respondent as gross income are in fact nontaxable loans obtained to finance various activities or are amounts properly attributable to Netta. He also argues that because his

principal occupation is gambling, expenditures made to various hotels and casinos in Las Vegas are expenses deductible against petitioner's gambling income.⁷

Respondent contends that petitioner received unreported income from investments in real estate, sales of farm goods, and other activities. Further, respondent contends that petitioner attempted to hide income from the Internal Revenue Service by listing various assets under his dominion and control in others' names, by concealing his ownership of certain real estate, and by conducting business transactions in a manner designed to avoid having the funds involved traced to him and to evade their seizure by respondent. As a result, respondent argues, petitioner's understatement of gross income was due to fraud within the meaning of section 6653(b). For the reasons discussed below, we agree with respondent.

The sources and expenditures method of calculating income is a valid method of determining income where a taxpayer has no books and records. Holland v. United States, 348 U.S. 121 (1954); Vassallo v. Commissioner, 23 T.C. 656 (1955). Petitioner has no books and records, and, we believe, failed to keep any. Petitioner bears the burden of proving that the determination of income calculated by respondent under the sources and expenditures method is incorrect. Vassallo v. Commissioner, supra at 662.

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These arguments were raised by petitioner at trial. Petitioner filed no briefs in this case.

Petitioner received income from the sale of wheat, cotton and cattle from the farm near Snyder, Oklahoma; from the rental of mobile homes, duplexes and houses held in his name or in Netta's; from the sale of various properties, including the Little Giant store and several parcels of the 105-acre tract; and, from the sale of cattle held in his name and in Netta's. None of this income, nor any related deductions or exclusions, was reported by petitioner. Instead, petitioner reported as income minimal amounts from "money made from poker games at my house," or from "operating a poker game, playing cards and shooting dice."

Further, petitioner acquired in Netta's name properties over which he exercised complete dominion and control. These included the Cache ranch, as well as various mobile homes, duplexes and houses on which petitioner received rental income. Petitioner was accountable to no other person for the management of these assets, the proceeds and income from which were applied solely for his own benefit. Proceeds from the \$175,000 loan, for which the Cache ranch--held in Netta's name--was pledged as security, were similarly applied to pay obligations and to purchase assets solely for the benefit of petitioner.

For the foregoing reasons, we find that the income from properties nominally held in Netta's name in truth belonged to petitioner and is taxable to him. Estate of Upshaw v.

Commissioner, 416 F.2d 737 (7th Cir. 1969), cert. denied 397 U.S. 962 (1970); Furnish v. Commissioner, 262 F.2d 727 (9th Cir. 1958).

Petitioner argues that respondent incorrectly determined petitioner's taxable income for the years at issue as a result of two errors. First, petitioner contends that his primary sources of funds were loans from various parties. Second, petitioner contends that he should be allowed to deduct hotel and casino expenses on the grounds his principal profession is gambling. The record provides no evidence to support petitioner's arguments.

As to petitioner's first argument, respondent has properly accounted for all verifiable loans in the calculation of petitioner's nontaxable sources of funds for the years at issue in this case. Beyond bare testimonial assertions by petitioner that certain other amounts received were loans, the record is barren of evidence to support his claim. We give no weight to petitioner's conclusory testimony otherwise unsupported by the record which, we believe, is unsupportable in fact.

Petitioner's second argument is also without sound footing in fact. Petitioner may deduct bona fide gambling losses evidenced by closed and completed transactions only to the extent of winnings from such activities. Section 165(d); sections 1.165-1(b) and 1.165-10, Income Tax Regs. Petitioner

has presented no evidence that payments made to various hotels and casinos were wagering losses, nor has he provided evidence of the extent of his wagering gains.⁸

Nevertheless, two items of income attributed by respondent to petitioner we find to be nontaxable in the years before us-- the proceeds from the sale of 1 Morford Drive and those from the sale of the Big Giant store. The property at 1 Morford Drive belonged to Netta from the time of the first divorce from petitioner in 1957, and there is no evidence in the record to show that the property was acquired by petitioner at any subsequent time. Therefore, the property belonged to Netta at the time of its sale. Netta endorsed the proceeds from the sale of the property to petitioner who used them exclusively for his personal purposes, but standing alone those facts do not support a finding that the sale proceeds are income to petitioner. There is nothing in the record to suggest that petitioner obtained the funds under false pretenses, in exchange for services or in any other manner that would render the funds taxable to him.

The installment payments received by petitioner for the sale of the Big Giant store in 1976 are not taxable to petitioner in the years received, since petitioner made no election to report such income on the installment method

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Cf. Kozma v. Commissioner, T.C. Memo 1986-177.

pursuant to the then existing requirements of section 453. Sec. 1.453-8(b)(1), Income Tax Regs. Such income is taxable in the year of sale. Therefore, we must conclude that the proceeds from the sale of the Big Giant store are nontaxable sources of income in 1977, 1978 and 1979.

Based on the foregoing, we conclude that petitioner has established that he did not underreport his income for the taxable year 1979. With respect to 1977 and 1978, except for the items noted above, we find petitioner's gross income and deductions to be as respondent has contended on brief. United States v. Johnson, 319 U.S. 503 (1943); Vassallo v. Commissioner, supra.

The final issue we must consider is whether petitioner's understatement of income for the taxable years 1977 and 1978⁹ was due to fraud with intent to evade tax within the meaning of section 6653(b). Respondent must establish, by clear and convincing evidence, that there is an underpayment of tax and that some part of this underpayment is due to fraud. Rule 142(b), Tax Court Rules of Practice and Procedure; section 7454(a). Although fraud may not be inferred from a mere understatement of income, consistent underreporting that is substantial either in amount or in proportion to the amount of income reported is persuasive evidence of fraudulent intent. Otsuki v. Commissioner, 53 T.C. 96 (1969); see also Stone v.

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Because we find that no underpayment exists for 1979, there can be no addition to tax for fraud for 1979.

Commissioner, 56 T.C. 213 (1971). Evidence of concealment or deception will also support a finding of fraud within the meaning of section 6653(b). Zell v. Commissioner, 763 F.2d 1139, 1144 (10th Cir. 1985).

The evidence in the record establishes clearly and convincingly that petitioner received substantial amounts of income from numerous sources which he failed to report on his Federal income tax returns for the taxable years 1977 and 1978. The record similarly establishes that petitioner conducted his business transactions in a manner designed to conceal both his assets and his tax liability for 1977 and 1978. Respondent has established the existence of an underpayment of tax for those years, and the evidence also clearly and convincingly establishes that some part of this underpayment was due to fraud. Therefore, we hold that section 6653(b) properly applies to the deficiencies for those taxable years.

To reflect the foregoing and concessions by the parties,

Decision will be entered
pursuant to Rule 155.

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T. C. Memo. 1986-238

ORIGINAL

UNITED STATES TAX COURT

HAROLD AND BETTY ASCH, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 10808-84.

Filed June 10, 1986.

Held, Ps are subject to the limitations on investment interest deductions contained in section 163, I.R.C. Held further, Ps are not entitled to a refund of Federal income taxes paid in 1981.

Harold Asch, pro se.

Alan G. Merkin, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

NIMS, Judge: Respondent determined a deficiency of \$26,889.38 in petitioners' 1981 Federal income tax. The issues for decisions are: 1) whether petitioners are subject to the

limitations on investment interest deductions contained in section 163(d);¹ and 2) whether petitioners are entitled to an income tax refund of \$1,000 for 1981.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and attached exhibits are incorporated herein by this reference.

Petitioners Harold Asch and Betty Asch, husband and wife, resided at Teaneck, New Jersey, when they filed the petition herein.

During 1981, Betty Asch (Betty) received wages of \$2,710 for services performed as a clerk for Consumers Utilities Service Corporation. During 1981, Harold Asch (hereinafter referred to as petitioner) received commissions totalling \$94,530.43 for services performed as a registered representative for Philips, Appel and Walden, Inc. (hereinafter referred to as PAW). Rule 10 of the Constitution and Rules of the New York Stock Exchange defines a registered representative as:²

[A]n employee engaged in the solicitation of orders for the purchase or sale of securities, or other similar instruments for the accounts of customers of his employer or in the solicitation of subscriptions to investment advisory or to investment management service furnished on a fee basis by his employer. The term "registered representative" does not apply to

¹ Unless otherwise indicated, all section references are to sections of the Internal Revenue Code of 1954 as amended and in effect during the year in issue. All rules references are to the Tax Court Rules of Practice and Procedure.

² As a registered representative, petitioner was subject to the Constitution and Rules of the New York Stock Exchange.

individuals who are engaged solely in the solicitation or handling of business in, or the sale of commodity contracts or who are engaged solely as securities traders, or securities arbitrageurs.

As a registered representative for PAW, the manner in which petitioner performed his job was controlled and directed by PAW. Each transaction petitioner executed on behalf of a customer was reviewed by a PAW compliance staff examiner. PAW required petitioner to maintain daily trading records for purposes of this review. PAW also required petitioner to secure its approval when opening new accounts and to account for any losses suffered by PAW which resulted from petitioner's error.

During 1981, PAW provided petitioner with office space, a desk, telephone services, direct wire services, securities quotations and accounting records. PAW also provided petitioner with coverage under its workmen's compensation insurance and medical insurance and made payments to the New Jersey Unemployment Insurance Fund for petitioner's benefit.

During 1981, each petitioner maintained a separate margin security account at PAW on which they incurred substantial interest expenses to purchase and carry securities. During 1981, they engaged in the following stock transactions:

<u>Stock</u>	<u>Date of Purchase³</u>	<u>Date of Sale</u>	<u>Short-Term Capital Gain (or Loss)</u>	<u>Long-Term Capital Gain (or Loss)</u>
Johnson & Johnson	10/30/80 & 11/11/80	1/7/81 & 1/12/81	\$ 25,147.15	\$ -
Teledyne Inc.	1/29/81	2/19/81	(6,561.34)	-
Superior Oil	3/20/81	2/26/81	3,199.27	-
McIntyre Mines, Ltd.	7/17/80 & 7/22/80	3/3/81	-	(9,381.15)
Kirby Expl. Co.	2/2/81	3/5/81	30,614.30	-
Syntex	1/7/81 & 1/15/81	-	(23,607.58)	-
Superior Oil	2/26/81	3/30/81 & 3/31/81	12,037.76	-
PDM	1/16/81 & 3/31/81	8/3/81	(56,046.66)	-
PDM	8/27/80 & 4/1/81	8/11/81	(66,842.49)	-
PDM	1974	8/11/81	-	54,622.27
SOC	3/19/81	2/26/81	2,129.74	-
Kirby Expl.	2/3/81	3/5/81	18,668.66	-
MP	6/3/81 & 7/21/81	3/18/81 & 3/26/81	(5,968.29)	-
SOC	2/26/81	3/31/81	8,491.80	-
SYN	4/1/81 & 4/2/81	4/23/81 & 5/1/81	(3,723.41)	-
Paradyne Corp.	4/24/81	6/11/81	(1,863.02)	-
PDM	1/19/81 & 4/15/81	8/3/81	(70,983.64)	-
PDM	7/21/80 & 5/18/81	8/3/81	(82,443.44)	-
PDM	1976 & 7/2/81	8/3/81	-	107,531.29
Total			<u>(\$217,751.19)</u>	<u>\$152,772.41</u>

On their 1981 joint Federal income tax return, petitioners reported dividend income of \$18,009 and interest income of \$40.12 from securities held in their margin security accounts. On Form 4952 (Investment Interest Expense Deduction) attached to their 1981 Form 1040, petitioners determined that some portion of the

³ We note that some of petitioners' stock sales preceded their stock purchases. Although not clear from the record, we assume that in these instances petitioners were selling short.

investment interest they incurred during 1981 to purchase and carry the securities held in their margin security accounts was not currently deductible under section 163(d). On Schedule A attached to their 1981 Form 1040, petitioners claimed \$55,157.76 of the total investment interest they incurred to purchase and carry securities during 1981. On a 1981 amended income tax return, however, petitioners claimed additional investment interest expenses of \$39,980.13. On the back of the amended return, petitioners stated "[i]nterest expense fully deductible in 1981. Error in computation on original return and only partially deducted."

In the notice of deficiency, respondent determined that petitioners were entitled to deduct investment interest of only \$28,049 as a result of the deduction limitations contained in section 163(d).

At the trial of this case, petitioner stated to the Court that he and Betty were entitled to an income tax refund of \$726.98 for taxable year 1981. The Court requested petitioners to file an amendment to petition stating a basis for their claim. The record was held open until July 8, 1985, for receipt of the amendment to petition. On June 13, 1985, petitioners submitted an amendment to their petition, which provided as follows:

The Petitioners in the above-entitled case are filing a cross-claim against Respondent in the amount of \$1,000 xx/100 re: Amended Tax Return - filed and mailed July 22, 1982.

OPINION

The first issue for decision is whether petitioners are subject to the limitations on investment interest deductions contained in section 163(d).

Section 163(a) provides "[t]here shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness." With respect to interest paid on investment indebtedness, however, section 163(d)(1) provides that in the case of a taxpayer other than a corporation, the amount of investment interest which would otherwise be allowable as a deduction is limited to \$10,000, plus the amount of net investment income produced by property owned by the taxpayer during the taxable year. Section 163(d)(3)(D) defines "investment interest" as "interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment."

Petitioners contend that during 1981 petitioner was engaged in the business of trading securities as an independent contractor for PAW, and, therefore, the interest petitioners incurred to purchase and carry securities for their own accounts was incurred in connection with a trade or business. Petitioners maintain that because section 163(d) does not limit the deductibility of interest incurred in connection with a trade or

business, the limitations contained in section 163(d) do not apply to the interest expenses which they incurred to purchase and carry securities.

Respondent agrees that section 163(d) would not limit the deductibility of petitioners' interest expenses if such expenses were incurred in connection with a trade or business.⁴

Respondent contends, however, that petitioners were not engaged in the business of trading securities for their own accounts during 1981, and, therefore, the interest expenses they incurred to purchase and carry securities were not incurred in connection with a trade or business. Respondent therefore concludes that petitioners' investment interest expenses are subject to the deduction limitations of section 163(d). We agree with respondent.

In determining whether a taxpayer who manages his own investments is engaged in a trade or business, the courts have distinguished between "traders" and "investors." It has been held that taxpayers who are security traders are considered to be engaged in a trade or business. Moller v. United States, 721 F.2d 810 (Fed. Cir. 1983); Groetzinger v. Commissioner, 82 T.C. 793 (1984), affd. 771 F.2d 269 (7th Cir. 1985), cert. granted ____ U.S. ____ (March 24, 1986). However, taxpayers who are simply

⁴ In House Report 91-413, Congress stated that section 163(d) is "applicable only to interest on indebtedness incurred or continued to purchase or carry property held for investment. * * * interest on funds borrowed in connection with a trade or business would not be affected by the limitation." H. Rept. 91-413 (Part 1) (1969), 1969-3 C.B. 200, 246.

investors in the stock market are not considered to be engaged in a trade or business, notwithstanding the frequency, extent and regularity of their investment activity. Higgins v. Commissioner, 312 U.S. 212 (1941); Moller v. Unites States, supra; Groetzinger v. Commissioner, supra.

In Liang v. Commissioner, 23 T.C. 1040, 1043 (1955), this Court distinguished between investment and trading accounts as follows:

[I]n the former, securities are purchased to be held for capital appreciation and income, usually without regard to short-term developments that would influence the price of the securities on the daily market. In a trading account, securities are bought and sold with reasonable frequency in an endeavor to catch the swings in the daily market movements and profit thereby on a short-term basis.

Relying on this language, the Court of Appeals for the Federal Circuit made the following distinction between a trader and an investor:

[I]n order to be a trader, a taxpayer's activities must be directed to short-term trading, not the long-term holding of investments, and income must be principally derived from the sale of securities rather than from dividends and interest paid on those securities. * * * [Moller v. United States, 721 F.2d at 813.]

Initially, we note that petitioners do not argue and the record contains no evidence that Betty participated in the management of her margin security account which she maintained with PAW during 1981. Thus, on the record before us, we find that Betty was not a securities trader during 1981, and, therefore, the interest she incurred to purchase and carry

securities during 1981 was not incurred in connection with a trade or business. Consequently, we find that her interest expenses are subject to the deduction limitations of section 163(d).

We are also satisfied that during 1981 petitioner was not engaged in the business of trading securities for his own account. During 1981, petitioners received commission, dividend and interest income totalling \$112,579.55 as compared to a net loss of \$64,978.78 on the sale of securities. Thus, during 1981, petitioner's gross income was principally derived from commissions, interest and dividends rather than from the sale of securities.

Moreover, during 1981, petitioners engaged in only 29 purchase transactions and 22 sales transactions. We do not think that the frequency of petitioner's security transactions evidences an "endeavor to catch the swing in the daily market movements." Taxpayers who previously have been found to be in the business of trading stock on their own account generally engaged in market transactions on an almost daily basis. See Levin v. United States, 597 F.2d 760, 765 (Ct. Cl. 1979); Fuld v. Commissioner, 139 F.2d 465 (2d Cir. 1943).

We also note that petitioner did not file a Schedule C (Profit or (Loss) From Business or Profession) with respect to any business of trading in securities during 1981. This fact is an additional indication that petitioner did not consider himself

to be engaged in the business of trading in securities during 1981. Purvis v. Commissioner, 530 F.2d 1332 (9th Cir. 1976), affg. per curiam T.C. Memo. 1974-164.

To support his position that the interest expenses he incurred to purchase and carry securities were incurred in connection with a trade or business, petitioner argues that he worked as an independent contractor, rather than as an employee, for PAW. We, however, do not find the character of petitioner's relationship with PAW determinative of the issue before us. We therefore need not and do not decide whether petitioner worked for PAW as an independent contractor rather than as an employee.

As a registered representative for PAW, petitioner solicited orders for the purchase and sale of securities from PAW's customers and executed such orders with third parties. Petitioner did not purchase securities from nor sell securities to PAW's customers. Moreover, his duties as a registered representative did not include the purchase and sale of securities for his own account. Thus, even if petitioner worked for PAW as an independent contractor rather than as an employee, the interest expenses he incurred to purchase and carry securities for his own account were not incurred in connection with his business as a registered representative. Consequently, we find that petitioner's interest expenses were not incurred in

connection with any trade or business and, therefore, are subject to the deduction limitations of section 163(d). Accordingly, respondent's determination is sustained.

Petitioners also claim in an amended petition that they are entitled to an income tax refund of \$1,000 for taxable year 1981. The record, however, contains no evidence to support petitioners' position that they are entitled to such refund. Consequently, petitioners' claim for refund is denied. Rule 142(a).

To reflect the foregoing,

Decision will be entered
for the respondent.

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T. C. Memo. 1986-239

ORIGINAL

UNITED STATES TAX COURT

BRUCE and JOANNE BROWN, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 15981-84.

Filed June 12, 1986.

Towner S. Leeper and David Leeper, for the petitioners.

David W. Johnson, for the respondent.

MEMORANDUM FINDINGS OF
FACT AND OPINION

KORNER, Judge: Respondent determined a deficiency in petitioners' Federal income tax in the amount of \$194,326, and an addition to tax under section 6653(b)^{1/} against petitioner Bruce Brown in the amount of \$98,424 for the taxable year ended December 31, 1978.

^{1/} All statutory references are to the Internal Revenue Code of 1954, as in effect in the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise noted.

The issues presented for decision are: (1) Whether the period of assessment of the tax due for petitioners' taxable year ended December 31, 1978, expired prior to May 15, 1984, the date on which respondent issued the notice of deficiency; (2) whether petitioners are entitled to a claimed casualty loss in the amount of \$364,900; (3) whether petitioners are entitled to an interest expense deduction in the amount of \$15,000; (4) whether petitioners are entitled to a depreciation deduction in the amount of \$13,496; (5) whether petitioners are entitled to an investment tax credit in the amount of \$9,097, including a claimed investment tax credit carryback from 1979 to 1978 in the amount of \$4,405; and (6) whether respondent has established by clear and convincing evidence that any underpayment of income tax was due to petitioner Bruce Brown's fraud with intent to evade tax under section 6653(b).

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts, supplemental stipulations of fact, and exhibits attached thereto are incorporated herein by this reference.

Bruce Brown ("Bruce" or "petitioner") and Joanne Brown ("Joanne") were husband and wife and residents of El Paso, Texas at the time the petition herein was filed. Bruce and Joanne filed a joint Federal income tax return for their taxable year

ended December 31, 1978. The 1978 return was received by the Internal Revenue Service Center in Austin, Texas, on May 21, 1979.

I

Petitioner was born on a farm in Alabama. He had been involved in the custom brokerage business since 1954. He owned all the stock of Brown's Refrigerated Warehouse, Inc., a public refrigerated warehouse located in El Paso, Texas. Petitioner also imported Mexican cattle, invested in feedlot operations, and operated a meat-packing plant and a food-processing company. Petitioner had no experience, however, in cattle ranching.

The A Bar A Ranch, subsequently known as the Cinco B Ranch, comprised approximately 1,166 acres of land located in Bandera County, Texas. In 1978, approximately 640 acres ("the 640-acre tract") were owned by the Estate of Isabel M. Anderson; her son, E. M. Anderson, Jr. ("Anderson"), owned approximately 526 acres ("the 526-acre tract")^{2/}. Anderson was the executor of his mother's estate.

By letter dated June 19, 1978, Bruce apprised his attorney, Bates Belk, that he was planning to acquire the above-mentioned tracts. Bruce wanted to exchange the 526-acre tract for other property in a tax-free transaction, if possible. The 640-acre tract was to be acquired by the PBJ Trust (see infra).

^{2/} Some of the exhibits describe this tract as having 532 acres. This inconsistency has no effect on our decision herein.

Petitioner stated in his letter that "Neither transaction will take place without the other," and that if the tax-free exchange was not feasible he would still try and buy the property.

The Estate of Isabel M. Anderson sold the 640-acre tract to Calvin Wallace for \$284,000 and, on June 30, 1978, Wallace sold the said 640-acre tract to the PBJ Trust for \$384,600. The PBJ Trust was created on September 1, 1977, pursuant to the terms of a trust agreement executed by petitioners. Bruce was the trustee and petitioners' children were the beneficiaries of the PBJ Trust.

By letter dated June 14, 1978, from Bruce to Anderson, Bruce requested a lease with an option to purchase the 526-acre tract ("lease-option agreement"). The said proposed agreement provided as follows, in pertinent part:

I am very interested in purchasing your property, but at this time I would prefer to lease all of the same with an option to purchase it. Considering the usefulness of the improvements and fixtures, and the value of the land and the location for both agricultural and other uses, the following offer to lease is made.

Lease

For a solid two (2) years, beginning on the date when you accept this entire offer (and which offer shall be void if not accepted by the close of business on June 30th, 1978) I will pay to you the sum of TEN THOUSAND & NO/100 (\$10,000.00) DOLLARS per year as lease or rent for the land and improvements. That is, I obligate myself to pay you \$20,000.00 for the 2-year period, payable \$5,000.00 now, and \$5,000.00 semi-annually thereafter until all of the rent is paid. In addition I will pay for insurance on all buildings, and maintain \$100,000/\$300,000 liability coverage at my expense.

While I will require immediate right to possession of the premises (I will want to move my horses in, have employees resident on the premises and have exclusive right to otherwise use and occupy the premises and improvements) you may be assured that if I don't keep the improvements up, or if I over-graze the land, destroy growing timber, alter any improvements or otherwise permit deterioration or waste of the premises without your written consent, you can kick me off by all lawful means. You will have the right to inspect at all reasonable times.

Option

During the period that I keep the terms of my lease, I will also have the exclusive option to purchase the real estate and improvements for the sum of SEVEN HUNDRED FIFTY THOUSAND & NO/100 (\$750,000.00) DOLLARS, payable as later set forth. For this option I will pay you \$65,000.00, \$32,500.00 now, and \$32,500.00 on or before December 30, 1978, with the understanding that if I don't make the December option payment, I will lose the option and the money I have paid on it.

On the other hand, I will have the right to exercise the option at any time, so I may decide to do this on or before the second payment date. If so, I will deposit \$32,500.00 with the title company you select as earnest money; and this option will then become a contract of sale performable within sixty days after I exercise the option. Of course, I will continue in possession under the above lease and continue to pay rent up to the date of closing. Also when the deal is closed the money I have paid for the option (or deposited as earnest money) will be credited on the cash part of the purchase price.

So long as the option exists as an option, time is of the essence, and my failure to perform will result in loss of all money paid for the option.

In order to exercise the option, I will be required to give you sixty days notice by certified or registered mail, return receipt requested at the address which you show below your name. You will then have that period of time to execute and deliver to me a deed with general covenants of warranty conveying fee simple title to said land subject only to utilities easements and liens for the unpaid part of the purchase price. At the time when you deliver the deed you will also obtain for my benefit

a guaranty title for \$750,000.00 containing no exceptions other than those printed in the form and those permitted in the deed.

In such case the closing may be earlier than sixty (60) days and at any time after you have given my [sic] ten (10) days written notice by registered or certified mail at my address shown below. At closing I will deliver the balance of the down payment, my promissory note for the deferred part of the purchase price, and my deed of trust additionally securing its payment.

The total down payment is \$150,000/00, and my note will be for the balance, bearing interest at 9.25%, payable in ten (10) consecutive equal annual installments of principal plus accrued interest beginning one year after the date of closing. Said note shall provide for 10% interest on matured and unpaid items, for acceleration of maturity upon default of any installment, and for reasonable attorney's fees if placed in the hands of an attorney for collection after maturity, or if collected through any court proceedings.

* * *

Tendered herewith is my check for \$37,500.00, \$5,000.00 being the first rental payment and \$32,500.00 the first option payment. If you find this acceptable, please sign in the space provided below, and attach a correct legal description. If you desire to place a value on your house and 3 to 4 acres, please do so and that will not be regarded by me as a change in the agreement. However, this offer must be accepted not later than the 30th of June, 1978.

Petitioner tendered his check dated June 26, 1978, in the amount of \$37,500, to Anderson with the lease-option agreement. The check was drawn on Bruce's account at the Bank of El Paso and was payable to Darrell Lochte, Escrow. A notation on the check indicated that the payment was made for "581 [sic] Acres, A-Bar-A, 6 Months Lease Purchase." Darrell Lochte was Anderson's attorney.

By letter dated June 30, 1978, Anderson accepted petitioner's lease-option proposal. Anderson further stated that should Bruce find an opportunity to use the 526-acre tract in a tax-free exchange, he would agree to a cancellation of the lease-option agreement, "provided only that I receive the same amount of money on the same terms which I would receive under your offer if it were fully performed." Enclosed with the letter was the lease-option agreement, signed by Anderson. In accordance with its provisions, Anderson attached a correct legal description of the property to the agreement.

Bruce's check, dated June 26, 1978, in the amount of \$37,500 was deposited into Lochte's escrow account at the First National Bank of Kerrville on July 5, 1978. On July 12, 1978, Lochte wrote a check, in the amount of \$37,500, payable to Anderson. The recited purpose on the check was "Bruce W. Brown Lease-Option Agreement." The said check was deposited into Anderson's account at the Schreiner Bank in Kerrville on July 13, 1978.

The Andersons did not move out of the A Bar A Ranch until the later part of July 1978. John Mantigold, Bruce's employee, moved to the ranch soon afterwards. Mantigold was Bruce's only permanent employee working on the ranch in 1978. Petitioners did not reside on the ranch in 1978; they resided in El Paso.

Don, Anderson's son, lived in one of the houses located on the 526-acre tract. He paid \$150 a month to Bruce in 1978 as rent, plus utilities.

Between August 1 and 3, 1978, the Medina River, which flowed adjacent to the 526-acre tract, flooded, reaching a crest of 45 feet. The flood resulted from 20 to 30 inches of rain falling on the area in the period.

On September 25, 1978, petitioner applied for a Small Business Administration ("SBA") loan, in the amount of \$735,000, for the purpose of repairing the damage caused to the A Bar A Ranch by the flooding of the Medina River. The SBA loss verifier, J. R. Fisher, found Bruce's estimate of damages unrealistic. He concluded that there was no damage to the dwellings on the premises or to the aircraft hangar, but that there was a heavy loss of trees along the river bank and heavy debris accumulation. The SBA approved a loan to petitioners, in the amount of \$147,800, on November 14, 1978.

Anderson acquired two insurance policies through Louis D. Chandler, an employee of Medina Insurance Agency, with respect to the A Bar A Ranch for the period between June 21, 1978, and June 21, 1979. The policies were not canceled prior to their termination date. Anderson did not carry flood insurance on the 526-acre tract during 1978.

In the fall of 1978, petitioner contacted Arlington Helbing and commissioned him to prepare an appraisal estimating the loss in the value of the 526-acre tract, and of the 640-acre tract owned by the PBJ Trust, caused by the flood of August 1978. Helbing delivered his report to petitioner on May 3, 1979,

indicating curable and incurable damage to the 526-acre tract of \$348,000 and to the 640-acre tract of \$17,000, for a total of \$365,000.

Bruce never exercised the option as set forth in the lease-option agreement by giving 60-days notice to Anderson by certified or registered mail, or otherwise.

Bruce directed Belk, in November 1978, to prepare a draft of an option agreement ("the November 1978 option") to supersede the lease-option agreement accepted by Anderson on June 30, 1978. Belk prepared the option agreement as per Bruce's instructions.^{3/} Anderson and Lochte discussed the provisions of the November 1978 option in November 1978, but it was not executed.

On December 22, 1978, petitioner purchased a cashier's check from the Bank of El Paso, in the amount of \$77,500, payable to Anderson. A meeting was held on December 26, 1978, in Lochte's office between Bruce, Anderson, and Lochte. Lochte took notes of what transpired at the said meeting, which notes were signed by

^{3/} The option agreement drafted by Belk provided that: (1) Bruce would have an option to buy the 526-acre tract for a period of 1 year commencing on June 30, 1978, in consideration for which petitioner had paid Anderson \$32,500; (2) Bruce would have the right to extend the option for a second year upon payment of \$32,500; (3) the purchase price of the property, should the option be exercised, would be \$750,000 payable as follows: \$100,000 at closing, less \$22,500 of each of the two option payments, which would be credited to the down payment; (4) \$10,000 of each \$32,500 payment would be considered as a rent payment; (5) the \$650,000 balance of the purchase price would be paid by Bruce's note, bearing interest at an annual rate of 9.25 percent, payable in 20 equal semiannual installments of principal, and interest on the unpaid balance commencing 6 months after the closing; and (6) the agreement would be effective as of June 30, 1978.

Bruce and Anderson. The notes set forth modifications to the terms of the lease-option agreement, as follows: (1) the down payment was to be \$100,000; (2) the \$650,000 balance was to be paid with a note bearing interest at an annual rate of 9.25 percent commencing on July 1, 1979; (3) the first payment, consisting of 6 months of interest, was due on January 1, 1980; and (4) principal and interest were to be paid in 30 semiannual installments, beginning on July 1, 1980. The check in the amount of \$77,500 was delivered to Anderson; \$67,500 of this amount was credited to the down payment.

The closing of the sale of the 526-acre tract occurred on February 6, 1979. The transaction could not be closed until February 6, 1979, because Bruce and Anderson did not reach a final agreement with respect to the terms of the sale until December 26, 1978, and not because of the tardiness of Lochte and/or Belk in preparing the necessary documents. The closing statement prepared by Lochte provided, in part, as follows:^{4/}

^{4/} The footnotes marked by asterisks were part of the document.

CLOSING STATEMENT

Date - Feb. 6, 1979*

E. M. Anderson, Jr. et ux to Bruce W. Brown, et ux

532 acres, various surveys, Bandera County

Total Sales Price	\$750,000
Insurance Proration	-0-
Gross Amount Due	<u>\$750,000</u>
Less Deductions:	
Purchase money note	650,000
Tax proration	-0-
Balance due	<u>\$100,000**</u>

* Effective date of deed is July 1st, 1978, the date when Purchasers gave verbal notice to Sellers that Purchasers exercised earlier option to purchase, with certain changes.

** This sum was paid directly to Sellers as option money and down payment.

Lochte prepared a Warranty Deed with Vendor's Lien, pursuant to the terms of which the Andersons conveyed the 526-acre tract to petitioners. The warranty deed was executed by the Andersons on February 6, 1979, but was back-dated so as to appear that it had been signed on July 1, 1978.

Lochte wrote petitioners on February 6, 1979, sending them, inter alia, a copy of the executed warranty deed, an original deed of trust to be executed by petitioners, and an original and a copy of a promissory note to be signed by petitioners.

The above-mentioned promissory note, dated July 1, 1978, was thereafter signed by petitioners. The note provided that the principal (\$650,000) and interest, from July 1, 1979, at the annual rate of 9.25 percent, were payable as follows: (1) one installment, due on January 1, 1980, of interest only; and (2) 30

semiannual installments, in the amount of \$40,493.35, representing principal and interest, payable on the first day of each July and January thereafter until all the principal and interest were paid, except that the last payment, due on January 1, 1995, was to be for \$40,492.85.

Petitioners executed the deed of trust that was enclosed with Lochte's letter with respect to the 526-acre tract in order to further secure the payment of the \$650,000 promissory note. The deed of trust was signed on September 24, 1979, and was filed with the clerk of the County Court of Bandera County, Texas, on March 14, 1980.

Anderson and his wife reported gain from the sale of the 526-acre tract to petitioners on their 1979 joint income tax return.

Bruce insured the A Bar A Ranch effective March 1, 1979, with John D. Williams Co. in El Paso, Texas. The title policy with respect to the conveyance of the 526-acre tract by the Andersons to petitioners was issued on March 14, 1980.

Bruce did not have legal or equitable title to the 526-acre tract as of August 3, 1978.

Gene Henderson, petitioners' accountant, prepared their joint income tax return for 1978 based on information provided to him by Bruce and his employees. Henderson was not provided with copies of the lease-option agreement; Anderson's acceptance of the lease-option agreement; the November 1978 option; Lochte's

notes dated December 26, 1978, signed by Bruce and Anderson; the warranty deed with vendor's lien; or the deed of trust; nor was Henderson aware of the existence of the aforesaid documents when he prepared petitioners' 1978 return. Henderson was provided, however, with the information contained in the closing statement dated February 6, 1979, and the appraisal report prepared by Helbing.

Petitioners claimed a casualty loss on Schedule A of their 1978 return, with respect to flood damage at the ranch (both tracts), as a personal casualty loss under section 165(c)(3), as follows:

Loss before insurance reimbursement	\$365,000
Insurance reimbursement	-0-
Statutory limitation	100
Casualty loss deduction claimed	<u>\$364,900</u>

Respondent disallowed the claimed casualty loss in his statutory notice of deficiency with the following explanation:

It is determined that the casualty loss of \$364,900.00 claimed on your return for the taxable year ended December 31, 1978 resulting from severe flooding on 532 acres of land along the Medina River is not allowable because you failed to show that you owned or had legal title to the acreage [sic] on or before the date of the flood or that any loss was incurred during 1978. Accordingly, your taxable income is increased in the amount of \$364,900.00.

II

Petitioners claimed no entitlement to an interest deduction with respect to the purchase of the 526-acre tract on their return for the taxable year ended December 31, 1978, but such claim was made, for \$15,000, in the first amendment to the petition filed on March 26, 1985. Petitioners made the first payment of interest with respect to the \$650,000 promissory note on January 7, 1980. The payment was in the amount of \$30,062.50; no amount of the said payment was credited to principal, and the balance due on the note remained \$650,000.

III.

Mantigold was petitioner's only permanent employee residing on the Ranch in 1978. It was not until 1979 that additional permanent employees were hired by petitioner.

Bruce did not purchase any cattle for the ranch until September 1979, when he purchased 35 head of cattle. The maximum number of cattle on the ranch between September 1979 and the year 1982 was approximately seventy-five. The combined carrying capacity of the 526-acre tract and the 640-acre tract owned by the PBJ Trust was 80 animal units -- either horses, cows, bulls, or sheep -- assuming that supplemental feed and hay were provided.

Petitioners did not make any expense-profit projection in order to ascertain what was the minimum number of cattle that had to be grazed on the ranch in order to obtain a profit. No Schedule F, Farm Income and Expenses, was attached to petitioners' return for the year 1978 and no income or expenses from ranching activities were reported on the said return. Schedule F was attached to petitioners' returns for the years 1979 through 1982, inclusive. In the said Schedule F attached to the returns petitioners reported income and expenses as follows:

	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>Total</u>
Income	\$ 7,913	\$ 9,984	\$ 78,929	\$ 50,118	\$ 146,944
Expenses	<u>194,970</u>	<u>353,815</u>	<u>554,072</u>	<u>397,211</u>	<u>1,500,068</u>
Net Profit or (Loss)	<u>(\$187,057)</u>	<u>(\$343,831)</u>	<u>(\$475,143)</u>	<u>(\$347,093)</u>	<u>(\$1,353,124)</u>

Petitioners did not report a profit from the ranching activities on their returns for the years 1983 and 1984.

In 1979, petitioners built a house costing approximately \$450,000 on the ranch, and remodeled the swimming pool and built a tennis court at a cost of approximately \$26,000 and \$8,000, respectively. One of the dwellings on the farm was remodeled, at a cost of approximately \$3,000, in order to convert it into an art studio for Joanne. Five other houses on the ranch were remodeled, an aircraft hangar was rebuilt, and underground fuel tanks were purchased and installed at a cost of approximately \$214,000, \$53,000, and \$29,549.50, respectively. An irrigation

system on the land was not installed. Electric fences were not installed, brush was not cleared, and hay was not planted until 1979.

Petitioners did not claim a depreciation deduction nor an investment tax credit with respect to property located at the 526-acre tract on their 1978 return, but such claims were made, in the respective amounts of \$13,496 and \$9,097,^{5/} in the first amendment to the petition filed on March 26, 1985.

Petitioners had previously filed Form 1045, Application for Tentative Refund, in which they claimed an unused investment tax credit carryback from 1979 to 1978 in the amount of \$4,405, with respondent. Respondent disallowed the claimed carryback in his notice of deficiency for 1978 with the following explanation:

It is determined that the deficiency herein constitutes a recover [sic] of a tentative allowance in the amount of \$4,405.00 made on September 15, 1980 as a result of Form 1045 being filed to carry back an unused investment tax credit for the taxable year ended December 31, 1979.

As part of a separate notice of deficiency to petitioners for the years 1976, 1977, and 1979 through 1982, respondent determined that petitioners' allowable investment tax credit for 1979 was \$11.

^{5/} How petitioners arrived at this total claimed credit is not disclosed in this record.

IV

Petitioners' return for their taxable year 1978 was selected for audit. Edwin Kurek, an engineer employed by the Internal Revenue Service in Texas, was assigned to petitioners' case and asked to determine whether the amount of the casualty loss claimed by petitioners on their return should be allowed in its entirety. For that purpose, Kurek visited the A Bar A Ranch on January 26, 1982, when he toured the ranch with Bruce and had an opportunity to review the damage done as a result of the flood of the Medina River in August 1978 and the repairs that had been made. Thereafter, Bruce was interviewed by Kurek and by Richard Schampers, an IRS agent, on June 14, 1983 and again on October 19, 1983.

During the course of the examination of petitioners' 1978 return, Bruce was asked on several occasions whether he had leased the 526-acre tract. On each and every occasion and at trial, petitioner denied having leased the 526-acre tract.

On October 5, 1983, Kurek visited Lochte's law office where he learned of the existence of the June 1978 lease-option agreement. Subsequently, on February 6, 1984, Kurek was able to obtain an unexecuted copy of the lease-option agreement from Lochte pursuant to an administrative summons.

On October 5, 1983, Kurek inspected the county deed records and obtained copies of the warranty deed and the deed of trust. Kurek phoned Anderson on October 17, 1983, and inquired about the

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particulars of the sale of the 526-acre tract to Bruce. Anderson said that he did not have a clear recollection of the events but that he would try and find his records in order to be able to answer Kurek's questions. Kurek called Anderson back on October 18, 1983, and described to him the lease-option agreement. Anderson admitted that he had a copy of the said agreement but stated that it was not executed.

On October 19, 1983, Kurek met with Henderson and Bruce in Henderson's office. Kurek requested that Bruce bring his records and any other documents related to the purchase of the 526-acre tract. Bruce brought: (1) Anderson's letter, dated June 30, 1978, accepting the lease-option agreement; (2) Bruce's check dated June 28, 1978, in the amount of \$37,500, payable to the order of Anderson; (3) the cashier's check from the Bank of El Paso, in the amount of \$77,500, payable to Anderson; (4) the unexecuted November 30, 1978 option; and (5) the \$650,000 promissory note dated July 1, 1978. With respect to the option dated November 30, 1978, Bruce told Kurek that he did not know why it was drafted and that the option was not his idea. Bruce did not tell Kurek that the \$650,000 promissory note was not prepared or executed until February 1979, nor did he furnish Kurek with copies of the December 26, 1978 agreement -- which altered the terms of the lease-option agreement -- the warranty deed, the deed of trust, or the notes taken by Lochte at the December 26, 1978 meeting that were signed by Anderson and

petitioner. Bruce showed a copy of the \$650,000 promissory note dated July 1, 1978, as evidence that he had purchased the 526-acre tract and represented to Kurek that that was the date on which he had given the note to Anderson. Petitioner never represented to Kurek that the "purchase" of the 526-acre tract took place on July 13, 1978, nor did he represent that he was the equitable owner of the said property. Kurek described the lease-option agreement and inquired whether petitioner had leased the property before purchasing it. Bruce answered that he had not leased the property and it had never been his intention to lease the property.

On February 6, 1984, Anderson was interviewed by Larry Zunker, respondent's special agent, and by Kurek. The interview was conducted in Lochte's office and in his presence and the proceedings were recorded and transcribed.

Anderson made numerous representations to respondent's agents including the following: (1) that the \$650,000 promissory note was dated July 1, 1978, by Lochte and was signed by petitioners on that date and in the presence of the Andersons; (2) that the promissory note provided that interest would accrue from July 1, 1979, but that the first interest payment was due on January 1, 1980, as a "perk" or incentive to Bruce who wanted additional time in order to raise money from the sale of certain business interests; (3) that he did not have a copy and did not execute the lease-option agreement; and (4) that he sold other

items to Bruce including a hunting buggy and a pick-up truck. Anderson also provided respondent's agents with copies of the following documents: (1) the November 1978 option; (2) a stamped slip dated July 13, 1978, acknowledging that the amount of \$37,500 had been deposited to Anderson's checking account at the Schreiner Bank in Kerrville; (3) a customer note ledger from the Schreiner Bank stating, inter alia, that on January 7, 1980, petitioner paid \$30,062.50 on the \$650,000 promissory note, which amount was interest, and that after crediting the said payment the balance due on the said note remained \$650,000; (4) a copy of a deposit slip to the above-mentioned checking account for \$77,500 dated January 2, 1979; (5) a copy of the \$650,000 promissory note; (6) a copy of the closing statement dated February 6, 1979; (7) a copy of the lease-option agreement; and (8) a copy of Anderson's acceptance letter dated June 30, 1978.

V

On November 18, 1981, petitioners signed Form 872, Consent to Extend the Time to Assess Tax, and thereby agreed to extend the period of assessment of tax for the year 1978 until December 31, 1982. Henderson signed the consent as petitioners' representative. The consent was executed by respondent on November 26, 1981. The period of assessment of the tax due for the year 1978 was further extended until December 31, 1983, by a

Form 872 executed by petitioners on July 30, 1982, and by respondent on August 2, 1982. This second Form 872 was also signed by Henderson as petitioners' representative.

A Form 872-A, Special Consent to Extend the Time to Assess Tax, was executed by petitioners on October 30, 1983, and was accepted on behalf of respondent on November 14, 1983. The special consent provided, in pertinent part, as follows:

(1) The amount(s) of any Federal Income tax due on any return(s) made by or for the above taxpayer(s) for the period(s) ended December 31, 1978, December 31, 1979, and December 31, 1980 may be assessed on or before the 90th (ninetieth) day after: (a) the Internal Revenue Service office considering the case receives Form 872-T, Notice of Termination of Special Consent to Extend the Time to Assess Tax, from the taxpayer(s); or (b) the Internal Revenue Service mails Form 872-T to the taxpayer(s); or (c) the Internal Revenue Service mails a notice of deficiency for such period(s); except that if a notice of deficiency is sent to the taxpayer(s), the time for assessing the tax for the period(s) stated in the notice of deficiency will end 60 days after the period during which the making of an assessment was prohibited. * * *

Petitioners executed a Form 872-T, Notice of Termination of Special Consent to Extend the Time to Assess Tax, on February 13, 1984. The notice of termination was signed by Bruce and by Henderson. On February 13, 1984, Henderson mailed the Form 872-T by certified mail, addressed to the "Internal Revenue Service Center, Austin, Texas 73301, Attention: Chief, Examination Division." The Form 872-T was received by the Internal Revenue Service Center in Austin, Texas, on February 17, 1984. The

office considering petitioners' case was the Internal Revenue Service office in El Paso, Texas. On May 15, 1984 -- 92 days after petitioners' accountant mailed the Form 872-T and 88 days after the said form was received by the Internal Revenue Center in Austin, Texas -- respondent mailed to petitioners a notice of deficiency for 1978, determining the deficiency and addition to tax in issue.

OPINION

Issue 1. Statute of Limitations

Petitioners argue that the notice of deficiency herein was untimely because it was issued 92 days after Henderson mailed the executed Form 872-T to respondent. Petitioners' argument is meritless and must be rejected.

Section 6501(a) provides the general rule that a deficiency in income tax shall be assessed within three years after the return is filed. An exception to this general rule is found in section 6501(c)(4), which provides as follows:

(4) Extension by agreement.--Where before the expiration of the time prescribed in this section for the assessment of any tax imposed by this title, except the estate tax provided in chapter 11, both the Secretary and the taxpayer have consented in writing to its assessment after such time, the tax may be assessed at any time prior to the expiration of the period agreed upon. The period so agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.

A consent to extend the period of assessment of an income tax is essentially a unilateral waiver of a defense by a taxpayer and is not a contract. Grunwald v. Commissioner, 86 T.C. 85 (1986); Piarulle v. Commissioner, 80 T.C. 1035 (1983); Tallal v. Commissioner, 77 T.C. 1291 (1981). Contract principles are significant, however, because section 6501(c)(4) requires that the parties reach a written agreement as to the extension. Grunwald v. Commissioner, supra; Piarulle v. Commissioner, supra.

The Form 872-A executed by petitioners and accepted on behalf of respondent provided, in pertinent part, that the amount of any Federal income tax due for the period ended December 31, 1978 "may be assessed on or before the 90th (ninetieth) day after: (a) the Internal Revenue Service office considering the case receives Form 872-T, Notice of Termination of Special consent to Extend the Time to Assess Tax, from the taxpayer(s) ***." (Emphasis added.) These are the terms of the agreement to which petitioners consented; there is no evidence that they tried to negotiate any different ones.

Notwithstanding the fact that the Form 872-T was signed on February 13, 1984, it was not mailed by petitioners' accountant to the Internal Revenue Service office in El Paso, Texas -- which was known by him to be the office considering petitioners' case -- but to the Internal Revenue Service Center in Austin, Texas. Respondent issued the notice of deficiency herein 88 days after

the receipt of the Form 872-T in Austin, on May 15, 1984.^{6/} Respondent has thus more than fully complied with the provisions of the agreement between the parties. Respondent's determinations are not barred by the statute of limitations.

Issue 2. Casualty Loss

Before addressing the remaining substantive matters presented by this case, we deem it proper to make some observations. First, the testimony of the witnesses in this case is plagued with inconsistencies that have made the fact-finding process unduly burdensome. Second, the demeanor and our view of the credibility of the witnesses, including petitioner, have played an important part in our determinations.

Section 165(a) allows as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise. In the case of an individual, the allowability of a deduction is limited by section 165(c) to: (1) losses incurred in a trade or business; (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and (3) losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft, to the extent that the amount of each of the said losses exceeds \$100.

^{6/} When the Form 872-T finally got to respondent's office in El Paso thus becomes irrelevant. In any case, it is not disclosed in this record.

It is black letter law that the loss must be sustained by the taxpayer who seeks to deduct it. New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934); Helvering v. Gordon, 134 F.2d 685 (4th Cir. 1943); Glasgow Village Development Corp. v. Commissioner, 36 T.C. 691 (1961); Rule 142(a).^{7/}

Petitioners claimed a casualty loss deduction in connection with the flooding of the Medina River between August 1 and 3, 1978, in the amount of \$364,900 (after subtraction of the \$100 statutory limitation) on line 29 of Schedule A attached to their 1978 return.^{8/} Respondent disallowed the claimed casualty loss in his statutory notice of deficiency, on the grounds that petitioners did not own nor have legal title to the 526-acre tract on or before the date of the flood.

In their petition filed on May 23, 1984, petitioners alleged that respondent had erred in determining that they were not entitled to the claimed casualty loss. In their second amendment to the petition filed on May 6, 1985, petitioners alleged that they had "acquired equitable title to the Cinco 'B' Ranch on or

^{7/} See also Henry v. Commissioner, T.C. Memo. 1983-277; Kennedy v. Commissioner, T.C. Memo. 1973-15; Tillapaugh v. Commissioner, T.C. Memo. 1972-5.

^{8/} Petitioners claim of a casualty loss under sec. 165(c)(3), subject to the \$100 statutory limitation therein is inconsistent with their claim that the property was acquired in a transaction entered into for profit. Losses with respect to property used in a trade or business or in an income-producing activity are deductible under secs. 165(c)(1) and (c)(2), whether or not they result from a casualty, and are not subject to the \$100 limitation in sec. 165(c)(3).

about June 30, 1978." At trial and on brief, petitioners argued that they assumed the benefits and burdens of ownership of the ranch in July 1978.

A portion of the \$365,000 claimed casualty loss -- before subtraction of the \$100 statutory limitation in section 165(c)(3) -- is attributable to damages to the 640-acre tract (\$17,000). As the parties stipulated, and as we have found, the 640-acre tract was sold by Wallace to the PBJ Trust, of which Bruce was the trustee, on June 30 1978. Petitioners do not contend, and the record does not show, that the PBJ Trust was a sham whose separate existence as a taxpayer must be disregarded. Therefore, this portion of the claimed casualty loss deduction must be disallowed since petitioners have failed to prove that they sustained the said loss.

Petitioners argue that: (1) Bruce was trying to arrange a tax-free exchange with Anderson pursuant to which Bruce was to acquire the 526-acre tract in exchange for Brown's Refrigerated Warehouse; (2) in the first part of July 1978, Anderson and his son, Don, traveled to El Paso to look at the refrigerated warehouse and decided that they were not interested in exchanging; (3) after Anderson notified him that he would not exchange the 526-acre tract for his property, Bruce told Anderson that he would purchase the 526-acre tract; (4) Anderson said that the \$37,500 check that Bruce had given Lochte "would serve;" (5) Lochte released the \$37,500 to Anderson after he was apprised of

the above-mentioned events; and (6) the said events constituted an oral exercise of the option granted to Bruce -- pursuant to the terms of the lease-option agreement -- that invested petitioner with equitable title to the 526-acre tract and enabled him to claim the loss here in issue.

The term "sale" is given its ordinary meaning for income tax purposes. A "sale" is generally defined as a transfer of property for money or a promise to pay money. Commissioner v. Brown, 380 U.S. 563 (1965). Generally, a sale of real property is complete upon the earlier of the transfer of legal title or the assumption of the benefits and burdens of ownership. Derr v. Commissioner, 77 T.C. 708 (1981); Baird v. Commissioner, 68 T.C. 115 (1977).

The lease-option agreement dated June 14, 1978, was signed and its terms accepted by Anderson on June 30, 1978. Pursuant to the terms of the said agreement, Bruce was to lease the 526-acre tract for a 2-year period. Bruce was to pay \$10,000 per year as rent, payable \$5,000 immediately and \$5,000 semiannually thereafter. During the 2-year period of the lease, Bruce had the exclusive option to purchase the leased property and improvements thereon for \$750,000. Petitioner was to pay \$65,000 for the option, \$32,500 immediately and \$32,500 on or before December 30, 1978. Should Bruce not make the December option payment, he would lose the option and the initial \$32,500 payment.

A lease is a transfer of an interest in and possession of property for a prescribed period of time in exchange for an agreed consideration called rent. State National Bank of El Paso v. United States, 509 F.2d 832 (5th Cir. 1975). In distinguishing between a contract of sale and an option, the inquiry must be whether one party is obligated to sell and the other to purchase, or whether there is conferred a right to purchase if there is an election to do so. Redwine v. Hudman, 104 Tex. 21, 133 S.W. 426 (1911); White v. Miller, 518 S.W.2d 383 (Tex. Civ. App. 1974). A contract for sale of real estate is an agreement which binds the purchaser to buy and the seller to sell in accordance with the terms of the contract. Lefevere v. Sears, 629 S.W.2d 768 (Tex. Ct. App. 1981); Tabor v. Ragle, 526 S.W.2d 670 (Tex. Civ. App. 1975). The purpose of a purchase option is to give the optionee the right to purchase at his election within an agreed period at a named price. Sinclair Refining Co. v. Allbritton, 147 Tex. 468, 218 S.W.2d 185 (1949). An option passes no title but prescribes conditions upon the occurrence of which an optionee may become entitled to demand passage of title. Click v. Seale, 519 S.W.2d 913 (Tex. Civ. App. 1975); Lusher v. First National Bank of Fort Worth, 260 S.W.2d 621 (Tex. Civ. App. 1953).

Petitioner had an irrevocable option -- conditioned upon either his making the December 1978 option payment or his exercising the option prior to the due date of the second option

payment -- good for 2 years, to purchase the 526-acre tract. Bruce made no promise of any kind but had an equal right to buy or not to buy. Anderson was bound by the agreement and the money provided therein as consideration not to sell the land to anyone other than petitioner during the 2-year period, provided that petitioner did not fail to make the December 1978 payment or exercised the right to purchase the 526-acre tract granted pursuant to the terms of the agreement prior to the due date for the second \$32,500 payment. We are satisfied that the agreement dated June 14, 1978, and signed and accepted by Anderson on June 30, 1978, granted to petitioner a 2-year lease with an option to purchase, and that it was not a contract of sale.

Petitioner's testimony that he did not lease the property nor execute an option to purchase it is contradicted by this record. Petitioner's check in the amount of \$37,500 was delivered together with the lease-option agreement. The said agreement specifically provided that "Tendered herewith is my check for \$37,500.00, \$5,000.00 being the first rental payment and \$32,500 the first option payment." Furthermore, the notation on the check indicated that the payment was made for "581 [sic] Acres, A-Bar-A, 6 Months Lease Purchase."

Until it is exercised, an option is not, in legal effect, a complete contract. White v. Miller, supra; McWhirter v. Morrow, 203 S.W.2d 317 (Tex. Civ. App. 1947). A written option to purchase real property may be orally accepted. San Antonio Joint

Stock Land Bank v. Malcher, 164 S.W.2d 197 (Tex. Civ. App. 1942). Unless the option contains provisions to the contrary, all that is required of the optionee is that he notify the optionor, prior to the expiration of the option, of his decision to exercise the option. Odum v. Sims, 609 S.W.2d 881 (Tex. Civ. App. 1980).

The lease-option agreement provided that in order to exercise the option Bruce was required to give Anderson 60-days notice, by certified or registered mail, and Anderson would then have 60 days to deliver a deed conveying fee-simple title to petitioner. Should petitioner decide to exercise the option before the date of the second option payment, he was to deposit \$32,500 with the title company selected by Anderson, as earnest money; the option would then become a contract of sale, performable within 60 days after the exercise of the option.

Where the option contains provisions stating the manner in which it is to be exercised, the option must be exercised, or as it is frequently stated, the option must be accepted, in accordance with its terms in order that it may ripen into a contract of sale. Zeidman v. Davis, 161 Tex. 496, 342 S.W.2d 555 (1961); White v. Miller, supra. To be effectual, acceptance of an option must be unqualified, absolute, unconditional, unequivocal, unambiguous, positive, without reservation, and according to the terms or conditions of the option. Hutcherson v. Cronin, 426 S.W.2d 638 (Tex. Civ. App. 1968). Substantial compliance with the terms of the option is insufficient to

constitute an acceptance; to be effectual, the acceptance must be identical with the offer or, at least, there must be no substantial variation between them. Hutcherson v. Cronin, supra; White v. Miller, supra. When the option is so exercised, the option contract is converted into an executory contract of sale, entitling the optionee to a conveyance and obligating him to perform the contract on his part. Hutcherson v. Cronin, supra. Although legal title does not pass under a contract of sale until actual delivery of a deed to the property to the purchaser, Lesson v. City of Houston, 243 S.W. 485 (Tex. Com. App. 1922), formation of the contract of sale passes equitable title to the purchaser. Lefevere v. Sears, supra; Hamon v. Allen, 457 S.W.2d 384 (Tex. Civ. App. 1970). The benefits and burdens of ownership are deemed to pass to the optionee-purchaser when equitable title is transferred. Boykin v. Commissioner, 344 F.2d 889 (5th Cir. 1965). Failure to strictly comply with the terms of the option agreement will be excused where the optionor waives his right to notice of the optionee's intention to exercise the option. Cattle Feeders, Inc. v. Jordan, 549 S.W.2d 29 (Tex. Civ. App. 1977); Jones v. Gibbs, 130 S.W.2d 265 (Tex. Com. App. 1939).

It is clear that Anderson retained legal title to the 526-acre tract until February 6, 1979, when the warranty deed with vendor's lien was executed by the Andersons. Petitioners contend, however, that: (1) Bruce orally exercised the option;

and (2) Anderson waived his right to 60-days notice of petitioner's intention to exercise the option by certified mail before the flood occurred.

The burden of proof is on petitioners, Rule 142(a). As we have found, petitioners' initial contention was that they had acquired legal title to the 526-acre tract on July 1, 1978. Bruce denied to respondent's agents and at trial that he had leased the property. According to petitioner, Anderson gave him an option to buy the 526-acre tract and he exercised it verbally; the \$37,500 payment was to buy the property.

As we have also found, Anderson was interviewed in Lochte's office and in his presence on February 6, 1984. The said interview was transcribed and forms part of the record herein. During the course of the interview, Anderson represented to respondent's agents that the \$650,000 promissory note was dated by Lochte on July 1, 1978, and was signed by petitioners on that date in Lochte's office and in the presence of Anderson and his wife. According to Anderson, Bruce took possession of the 526-acre tract on July 1, 1978, "that's when we said, it's your ranch." In explaining why interest on the promissory note was not due until January 1, 1980, even though it accrued from July 1, 1979, Anderson stated that it was a "perk" or incentive that he had given petitioner. Bruce was, stated Anderson, selling Jerky Treats, Inc., one of his businesses, and wanted to postpone the payments on the note until he got the money from the

purchaser. Anderson denied having a copy of the lease-option agreement or executing or accepting the said agreement "because he [Bruce] decided that he didn't want to do it that way," and because "the Hart [sic] deal came through quicker than he expected." It was only when he was confronted with his acceptance letter dated June 30, 1978, that Anderson admitted having signed and accepted the lease-option agreement. There was no mention of Bruce's exercising the option after Anderson allegedly declined to exchange the 526-acre tract for Brown's Refrigerated Warehouse.

At trial, however, Anderson testified that he executed the lease-option agreement, and that Bruce had provided him with a brochure of the refrigerated warehouse and suggested an exchange of the two properties. Anderson also testified that right after July 4, 1978, he flew to El Paso with his wife and son and toured the facilities and decided not to go ahead with the exchange and notified petitioner accordingly. Petitioner, said Anderson, then decided that he would go ahead with the purchase of the property as per the terms of the lease-option agreement. Anderson said he told petitioner that "the check will serve" and that Lochte was apprised of the fact that the option had been exercised and instructed to distribute the \$37,500 that he had deposited in his escrow account to Anderson. Petitioner similarly testified that

he had exercised the option around July 9, 1978, and that he was the one who authorized Lochte to distribute the \$37,500 to Anderson.

Petitioner apprised Belk, by letter dated June 19, 1978, of his intention to acquire the A Bar A Ranch; the 640-acre tract was to be acquired by the PBJ Trust, the 526-acre tract was to be acquired by Bruce personally in a tax-free exchange if possible. The letter described in detail the tax-free exchange that Bruce was planning. Anderson was aware of Bruce's intentions as demonstrated by his letter dated June 30, 1978, in which he accepted the provisions of the lease-option agreement and in which he stated that "if during the period of this agreement you find an opportunity to use my property in a tax-free exchange then I will agree to a cancellation of the Lease and Option to Purchase, providing only that I receive the same amount of money on the same terms which I would receive under your offer if it were fully performed" (emphasis added). We find it hard to believe that after stating the foregoing, Anderson would fly to El Paso five or six days later, in order to consider exchanging his property for Brown's Refrigerated Warehouse.

Bruce and Anderson's testimony -- that the provisions contained in the option agreement concerning the payment of the second option payment, in the amount of \$32,500 were waived, that

the option was verbally exercised, and that Lochte was then instructed by Bruce to disburse the \$37,500 check to Anderson -- is similarly contradicted by Lochte's testimony.

Lochte testified that the \$37,500 check dated June 26, 1978, was tendered in conjunction with the lease-option agreement, and was a "payment to which Mr. Anderson was entitled." Bruce handed him the check for distribution to Anderson, and after having the check credited to his escrow account, Lochte wrote his own check to Anderson. The delay between the date on which the check was tendered and deposited to Anderson's account was due to Lochte's having to wait for the check to clear before giving Anderson his own check, and not to his waiting for Bruce's authorization to release the money to Anderson.

Petitioners have not only failed to prove affirmatively with credible evidence that the option was effectively exercised before the date of the flood, but have also failed to satisfactorily explain why -- if the option was exercised before August 1978 -- another option intended by its own terms to supersede the June 30, 1978 lease-option agreement was even considered by Anderson and Lochte in November 1978.

Bruce testified that he asked Belk to prepare the November 1978 option based on the letter dated June 19, 1978, and around that date, but that Belk had procrastinated and did not prepare the option until November 1978. Again, petitioner's testimony was contradicted by Belk who stated that he had

prepared the option dated November 30, 1978, as per Bruce's request around November 30, 1978. We also note that the terms of the lease-option agreement dated June 30, 1978, were modified on December 26, 1978 -- with respect to the amount of the down payment, the principal of the promissory note, and the payout terms of the promissory note -- at a meeting between petitioner, Anderson, and Lochte, and that Lochte's handwritten notes were signed by petitioner and Anderson to signify a final agreement. At this time, or shortly before, Bruce transferred to Anderson a check for \$77,500.

According to petitioner, the purpose of this meeting was to pay Anderson some money and to finish the transaction. He testified that: "I had been screaming for the warranty deed and the deed of trust for some months and Lochte never got around to preparing the darn thing." Petitioner also stated that the closings on the sale of the two tracts were so far apart -- June 30, 1978, and February 6, 1979 -- because Lochte and Jackson "did not get their homework done." However, we are satisfied that, as stated by Lochte, the deed, the promissory notes, and the other documents necessary for the closing of the transaction could not have been prepared before December 26, 1978, because the final terms of the sale were not agreed to until that date. It is noteworthy that the said meeting took place on December 26, 1978, right before the deadline provided in the lease-option agreement for Bruce to make the second option payment in the

amount of \$32,500 - or otherwise lose the option and the \$32,500 already paid by him. It is also noteworthy that the deed conveying fee-simple title (the warranty deed with vendor's lien) was executed on February 6, 1979, within 60 days of December 26, 1978.

Petitioners attempt to overcome the import of the unambiguous lease-option agreement by emphasizing that both Bruce and Anderson were ultimately interested in purchasing and selling the 526-acre tract, respectively. However, as stated in the lease-option agreement, even though petitioner was very interested in purchasing the 526-acre tract, he wanted to lease it with an option to purchase. Neither Lochte nor Belk had personal knowledge of when the alleged exercise of the option took place. Lochte was instructed to date all the documents necessary for the transactions as of July 1, 1978. Anderson testified as follows:

Q. If you will look in the middle of the paragraph by the single asterisk, it says "effective date of deed is July 1, 1978."

A. Uh-huh

Q. Did you instruct Mr. Lochte to place this statement on the closing statement?

A. That was when the lease option started and that is when the ranch was -- everything started and we said he would date it back to that date.

Q. Who said to do that?

A. I did, I guess.

Q. Why?

A. Well, because that is when it started.

Q. What started?

A. The transaction. [Emphasis added.]

We find that as a matter of fact and law, Bruce did not have legal or equitable title to the 526-acre tract as of August 3, 1978. We are also satisfied that the option was not exercised and that a mutually binding contract of sale was not entered into until December 26, 1978, when Brown manifested his intention to buy the property and made the second option payment, and the parties to the transaction reached a final agreement with regard to the amount of the down payment and the promissory note, and the payment schedule of the promissory note. Even if there was an understanding, prior to the flood, that an agreement would be reached at a later date on the terms of a sale, in order that there be a sale for tax purposes there must be no less than a binding agreement that the title will be conveyed by the vendor to the vendee for a stated or determinable consideration payable in a specified manner. Dezendorf v. Commissioner, 312 F.2d 95 (5th Cir. 1963), affg. T.C. Memo. 1961-280; 2 Mertens, Law of Federal Income Taxation sec. 12.126 (1985).

The fact that petitioners acquired possession before the flood or that Anderson's son, Don, paid them rent is of no consequence in our determination. The owner of a leasehold

estate is entitled to possession of the premises during its existence, as he would have been if he had purchased fee-simple to the land. Mallom v. Trans-Texas Airways, 227 S.W.2d 344 (Tex. Civ. App. 1950); Galley v. Hedrick, 127 S.W.2d 978 (Tex. Civ. App. 1939). This implies the right to charge rent to one that lives on the property.

It follows that petitioners are not entitled to the claimed casualty loss deduction in the amount of \$364,900.

Issue 3. Interest Expense Deduction

Petitioners claimed no entitlement to an interest deduction with respect to the purchase of the 526-acre tract in their 1978 return. Such claim was made, however, in the amount of \$15,000, in the first amendment to the petition filed on March 26, 1985.

Petitioner tendered his check dated June 26, 1978, in the amount of \$37,500, payable to Darrell Lochte, Escrow, with the lease-option agreement. The said check constituted payment of the first option payment, in the amount of \$32,500, and of the \$5,000 due as rent for the first 6 months of the lease. On December 22, 1978, Bruce purchased a cashier's check in the amount of \$77,500 from the Bank of El Paso, payable to Anderson and delivered it to Anderson. On December 26, 1978, Anderson and Bruce agreed to modify the terms of the lease-option agreement in that: (1) the down payment was reduced from \$150,000 to \$100,000; (2) the balance of the purchase price (\$650,000) was

due to be paid with a note bearing interest at a rate of 9.25 percent accruing from July 1, 1979; and (3) the first payment consisting of interest only, from July 1, 1979, was due on January 1, 1980.

Petitioners argue that the excess of the sum of the two checks paid to Anderson (\$115,000)^{9/} over the amount of the down payment (\$100,000), or \$15,000, constitutes interest paid and deductible by them.

Section 163(a) allows a deduction, in the case of a cash basis taxpayer, for interest paid within the taxable year on indebtedness. Helvering v. Price, 309 U.S. 409 (1940); Christensen v. Commissioner, 40 T.C. 563 (1963). Petitioners bear the burden of proving that the claimed amount was paid to Anderson as compensation for the use or forbearance of money. Deputy v. duPont, 308 U.S. 488 (1940); Rule 142(a).

As we have held, supra, the check in the amount of \$37,500 constituted payment of rent (\$5,000) and the first option payment (\$32,500), which was creditable towards the down payment. The second check in the amount of \$77,500 constituted payment of the second option payment (\$32,500) and of \$35,000 to complete the

9/ As follows:

Check dated June 26, 1978 payable to Darrell Lochte, Escrow	\$ 37,500
Check dated December 22, 1978 payable to E. M. Anderson, Jr.	77,500
Total	<u>\$115,000</u>

\$100,000 down payment. Petitioners have failed to prove that the \$10,000 that were not otherwise accounted for were paid for interest.

Under the terms of the \$650,000 promissory note, interest was to accrue, at an annual rate of 9.25 percent, from July 1, 1979. The first payment on the note in the amount of \$30,062.50, constituting interest only, was due on January 1, 1980. This payment was made on January 7, 1980, according to the customer note ledger prepared by Schreiner Bank. No payments of interest or principal were made before this date. No interest payments were due or payable in 1978.

Other than petitioner's self-serving testimony, the record is devoid of any evidence that the additional \$10,000 paid was paid as interest and not for the purchase of other assets, rent, or anything else. Petitioners are therefore not entitled to the claimed interest expense deduction.

Issue 4. Depreciation Deduction and

Issue 5. Investment Tax Credit

Petitioners did not claim a depreciation deduction nor an investment tax credit with respect to the 526-acre tract on their return for the taxable year ended December 31, 1978. Such claims were made, however, in the respective amounts of \$13,496 and \$9,097, in the first amendment to the petition filed on March 26, 1985. In support of their contentions, petitioners argue that

they acquired the 526-acre tract and the improvements thereon with the intention of making a profit from the sale of cattle, a pecan-shelling operation, and renting the dwellings on the property.

Respondent denies that petitioners had a profit motive to enter into this transaction and argues the applicability of section 183^{10/} to deny the claimed deductions.

10/ Sec. 183 provided, in pertinent part, as follows, during the years in issue:

SEC. 183. ACTIVITIES NOT ENGAGED IN FOR PROFIT.

(a) General Rule.--In the case of an activity engaged in by an individual or an electing small business corporation (as defined in section 1371(b)), if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.

(b) Deductions Allowable.--In the case of an activity not engaged in for profit to which subsection (a) applies, there shall be allowed--

(1) the deductions which would be allowable under this chapter for the taxable year without regard to whether or not such activity is engaged in for profit, and

(2) a deduction equal to the amount of the deductions which would be allowable under this chapter for the taxable year only if such activity were engaged in for profit, but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1).

(c) Activity Not Engaged in for Profit Defined.--For purposes of this section, the term "activity not engaged in for profit" means any activity other than one with respect to which

(footnote continued)

Section 183(a) provides that if any individual's activity constitutes an activity "not engaged in for profit," the deductions arising out of such activity shall not be allowed except as provided in section 183(b). An "activity not engaged in for profit" is defined in section 183(c) as "any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212." If the activity is not engaged in for profit, section 183(b) separates the claimed deductions into two groups. Section 183(b)(1) allows only those deductions which are not dependent upon a profit motive, e.g., interest and taxes. Section 183(b)(2) allows the balance of the deductions which would otherwise be permitted only if the activity was engaged in for profit to the extent that the gross income derived from the activity exceeds the deductions allowed under section 183(b)(1).

In order to constitute the carrying on of a trade or business under section 162 or an activity for the production of income under section 212(1) or (2), petitioners must establish that they engaged in the activity with an actual and honest objective of making a profit. Dreicer v. Commissioner, 78 T.C. 642 (1982), affd. without opinion 702 F.2d 1205 (D.C. Cir. 1983). See also Brannen v. Commissioner, 722 F.2d 695 (11th Cir. 1984), affg. 78 T.C. 471 (1982); Hager v. Commissioner, 76 T.C. 759

(footnote continued from previous page)
deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212.

(1981), and cases cited therein. "Profit," in this context, means economic profit, independent of tax savings. Surloff v. Commissioner, 81 T.C. 210 (1983).

The issue of whether a taxpayer engages in an activity with the requisite intention of making a profit is one of fact to be resolved on the basis of all the surrounding facts and circumstances. Sec. 1.183-2(b), Income Tax Regs.; Engdahl v. Commissioner, 72 T.C. 659 (1979); Allen v. Commissioner, 72 T.C. 28 (1979). In determining whether an activity is engaged in for profit, the following factors are to be considered: (1) the manner in which the taxpayer carried on the activity; (2) the expertise of the taxpayer or his advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or loss with respect to the activity; (7) the amount of occasional profit, if any, which is earned; (8) the financial status of the taxpayer; and (9) whether elements of personal pleasure or recreation are involved. Sec. 1.183-2(b), Income Tax Regs.; Boyer v. Commissioner, 69 T.C. 521 (1977); Benz v. Commissioner, 63 T.C. 375 (1974). It is not intended, however, that only the aforesaid factors be taken into account in making the determination. Sec. 1.183-2(b), Income Tax Regs.

Respondent's determination is presumptively correct. Welch v. Helvering, 290 U.S. 111 (1933). The burden of proving the requisite profit objective is on the taxpayer. Rule 142(a). The presumption in section 183(d) is not applicable to the facts herein.

Petitioner testified that he considered that there were three profit centers on the ranch: (1) a cattle operation; (2) a pecan-shelling operation; and (3) the possibility of renting some of the houses located on the property during the summer.

Bruce was born on a farm in Alabama. He had been involved in the custom brokerage business since 1954, and owned all the issued and outstanding stock of Brown's Refrigerated Warehouse. He also imported Mexican cattle, invested in feedlot operations, and operated a meat-packing plant and a food-processing company. He had, however, no experience in cattle ranching. Other than having stored pecan nuts in his refrigerated warehouse, the record does not disclose any prior experience of petitioner in conducting a pecan-shelling operation.

Petitioners did not make any expense-profit projection in order to ascertain what was the minimum number of cattle that had to be grazed on the ranch to obtain a profit. They similarly did not inquire what Anderson's profit or loss experience was. The record is devoid of evidence as to whether petitioners consulted

any experts or advisors. During 1978, there was only one permanent employee residing on the ranch. It was not until 1979 that petitioner hired additional permanent employees.

Petitioners did not provide us with copies of their books or records. Petitioners did not attach a Schedule F, Farm Income and Expenses, to their 1978 return, nor did they report any income or expenses from ranching activities. Petitioners did attach a Schedule F to their returns for the years 1979 through 1982, inclusive. They reported losses for all those years as stated in our findings of fact, supra.

Bruce did not purchase any cattle for the ranch until September 1979, when he purchased 35 head of cattle. The maximum number of cattle on the ranch between September 1979 and the year 1982 was approximately 75. The combined carrying capacity of the 640-acre tract belonging to the PBJ tract and the 526-acre tract was 80 animal units. There is no evidence of the measures, if any, that were taken by petitioners to increase the possibility of obtaining a profit from their operation.

During 1979 and subsequent years, petitioners built a house on the ranch (\$450,000), remodeled the swimming pool (\$26,000), built a tennis court (\$8,000), remodeled one of the houses on the property in order to convert it into an art studio for Joanne (\$3,000), remodeled five other houses on the ranch (\$214,000), rebuilt an aircraft hangar (\$53,000), and purchased and installed underground fuel tanks (\$29,549.50) at a total cost of

approximately \$783,549.50. The connection between these expenditures and the furtherance of the alleged "profit-centers operations" was not explained at trial, and is not apparent to us. An irrigation system was not installed because petitioners "ran out of money." Electric fences were not installed, brush was not cleared, and hay was not planted until 1979.

In sum, petitioners have failed to prove that in 1978 they engaged in any activity on the ranch as a trade or business or for profit. Since no income was reported or derived from the activity in 1978, petitioners' claimed depreciation deduction and investment tax credit must be disallowed, so far as events occurring in that year are concerned. Secs. 38, 46, 48, 162, 167, 183.

Petitioners filed a Form 1045, Application for Tentative Refund, with respondent. On the said form, petitioners claimed an unused investment tax credit carryback from 1979 to 1978 in the amount of \$4,405. Respondent disallowed the claimed carryback (see our findings of fact, supra) in his notice of deficiency.

Petitioners bear the burden of proving that (1) they had an investment tax credit carryback available from 1979; (2) the said carryback was not used in 1976 or 1977; and (3) the claimed amount remained to be carried back to 1978. Sec. 46(b); Rule 142(a).

The record herein is devoid of any evidence in support of petitioners' claim. Petitioners requested that we find as a fact that "In 1979 petitioners incurred an operating loss of \$187,957.00 on the Cinco "B" Ranch and were entitled to carryback investment credit on purchases to prior years in the amount of \$22,084.00." The said proposed finding of fact is, according to petitioners, supported by the Form 1045, and by petitioners' return for the year 1979.

Tax returns are not self-proving, Halle v. Commissioner, 7 T.C. 245 (1946), affd. 175 F.2d 500 (2d Cir. 1949), cert. denied 338 U.S. 949 (1950), nor is a form attached to the return or thereafter filed with respondent. Petitioners have failed to show error in the notice of deficiency. Their claim of entitlement to an investment tax credit carryback, in the amount of \$4,405, from 1979 to 1978 must be denied for failure of proof.

Issue 6. Fraud

The only remaining issue for decision is whether petitioner Bruce is liable for the addition to tax under section 6653(b) as determined by respondent in his notice of deficiency.^{11/}

^{11/} As effective for the year 1978, sec. 6653(b) read as follows:

(b) Fraud.--If any part of any underpayment (as defined in subsection (c)) of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 50 percent of the underpayment. In the case of income taxes and gift taxes, this amount shall be in lieu of any amount

(footnote continued)

Fraud is an actual, intentional wrongdoing, and the intent required is the specific purpose to evade a tax believed to be owing. Webb v. Commissioner, 394 F.2d 366, 377 (5th Cir. 1968), affg. T.C. Memo. 1966-81. Whether fraud exists is a question of fact to be decided upon the entire record. Rowlee v. Commissioner, 80 T.C. 1111, 1123 (1983); Gajewski v. Commissioner, 67 T.C. 181, 199 (1976), affd. without published opinion 578 F.2d 1383 (8th Cir. 1978). Respondent has the burden of proving fraud by clear and convincing evidence. Sec. 7454(a); Rule 142(b); Stone v. Commissioner, 56 T.C. 213 (1971). Respondent must establish that: (1) there was an underpayment of taxes; and (2) part of the underpayment was due to taxpayer's fraud. Hebrank v. Commissioner, 81 T.C. 640 (1983). Fraud is never presumed, Beaver v. Commissioner, 55 T.C. 85, 92 (1970), but may be proved by circumstantial evidence because direct proof of the taxpayer's intent is rarely available. Stephenson v. Commissioner, 79 T.C. 995, 1005-1006 (1982), affd. 748 F.2d 331 (6th Cir. 1984). The taxpayer's entire course of conduct must be examined to determine whether the requisite fraudulent intent is present. Stone v. Commissioner, 56 T.C. at 223-224. Mere negligence is not proof of fraud; an intent or purpose to evade

(footnote continued from previous page)

determined under subsection (a). In the case of a joint return under section 6013, this subsection shall not apply with respect to the tax of a spouse unless some part of the underpayment is due to the fraud of such spouse.

tax is essential. Estate of Briden v. Commissioner, 11 T.C. 1095 (1948), affd. sub nom. Kirk v. Commissioner, 179 F.2d 619 (1st Cir. 1950).

Finally, respondent may not rely on the presumptive correctness of his statutory notice to assist him in carrying his burden of proof on the fraud issue. The presumption of correctness which attached to respondent's deficiency notice is merely a procedural device, not a substitute for evidence.

Rockwell v. Commissioner, 512 F.2d 882, 885 (9th Cir. 1975), cert. denied 423 U.S. 1015 (1975). Although respondent can rely on the presumption of correctness which attaches to his statutory notice in support of the deficiency, he may not so rely with respect to issues on which he has the burden of proof, as here.

We have made extensive findings of fact about Bruce's lack of forthrightness with respect to the transactions involving the 526-acre tract, and need not repeat them here. While we realize that it is sometimes hard for taxpayers to have a clear recollection of events that happened years ago, we are convinced that petitioner's untruthful statements were not due to natural forgetfulness, but to an actual intent to mislead respondent and this Court into believing that he had never leased, nor intended to lease, the 526-acre tract, and that the back-dated documents transferring him legal title of the property had actually been signed on July 1, 1978, or that the option was exercised soon thereafter, in July 1978. All such deceptive conduct was

intended to support Bruce's claim to a casualty loss because of the flood at the ranch at a time when he was not the owner, and he knew it. When confronted with his inconsistent statements, petitioner testified as follows:

A. I am sure that I told Schampers [the revenue agent] I signed this thing on July 1, '78, which was wrong. I signed it in February of '79, but I didn't remember at the time whether I had signed it in '78 or '79, but it didn't really matter. The darn documents had not been prepared. There is certainly nothing wrong with backdating the date on a piece of real estate. It is done every day. You don't get realtors and lawyers to get their documents done on time.

To this cavalier statement of petitioner we observe: in this wicked world in which we live, it may be true that documents are back-dated every day. Sometimes the reasons may be innocent and the results innocuous; but where a taxpayer deliberately back-dates documents in order to support a substantial deduction claim on his income tax return -- a deduction to which he knows he is not entitled -- there is definitely something wrong about it within the meaning of section 6653(b).

Furthermore, we find no innocent explanation for petitioners' claiming a loss deduction of \$17,000 with respect to the 640-acre tract, which petitioner stipulated was owned by another taxpayer, the PBJ Trust.

Respondent's determination that petitioner is liable for the fraud addition is sustained.

To reflect the foregoing,

Decision will be entered
for the respondent.

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T. C. Memo. 1986-240

UNITED STATES TAX COURT

LESTER HOWARD KAHL, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 868-79.

Filed June 16, 1986.

Joseph L. Wyatt, Jr., Laura Stern Seaver, and James R.
McDaniel, for the petitioner.

Karl D. Zufelt, for the respondent.

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MEMORANDUM FINDINGS OF FACT AND OPINION

COHEN, Judge: Respondent determined the following deficiencies in petitioner's Federal income taxes:

<u>Year</u>	<u>Deficiency</u>
1972	\$ 2,038.72
1973	1,189,864.53
1975	121,191.19

After concessions, the issues for decision are whether petitioner reinvested proceeds of an involuntary conversion in property entitling him to nonrecognition of gain under section 1033¹ and whether petitioner sustained a deductible theft loss in 1975.

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts and attached exhibits are incorporated herein by this reference.

Petitioner resided in Hemet, California, when he filed his petition in this case. He filed Federal income tax returns for the taxable years 1972, 1973, and 1975.

The Tucson Property

In 1969, petitioner learned that the State of Arizona and the City of Tucson, Arizona, were threatening to condemn a 350 acre parcel of real property held by him for investment and

1

Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue.

located in Tucson, Arizona (the Tucson Property). On April 1, 1973, petitioner sold the Tucson Property under the threat of condemnation for \$3,750,000.

Between February 1971 and January 1972, petitioner purchased in his name and for investment parcels of real property in the United States for a total cost of \$118,458.86

Costa Rican Activities

Formation of IPSA

In 1974, petitioner contacted the Consul General of Costa Rica in Los Angeles, California, and requested guidance in purchasing real property in Costa Rica. It was recommended that petitioner engage the assistance of Sr. Carlos Loria (Loria), a Costa Rican attorney and cousin of the Consul. The Consul notified Loria that petitioner would contact him.

In February or March 1974, petitioner and his brother traveled to Costa Rica and met with Loria. There, they discussed petitioner's desire to use proceeds from the sale of the Tucson Property to purchase real property in Costa Rica. Petitioner explained that he would not return to Costa Rica until later in 1974. Although petitioner intended to make the investments in his own name, Loria advised him that a Costa Rican corporation would be necessary for petitioner to invest in Costa Rican properties and that petitioner should make Loria an officer of the corporation to enable Loria to act on petitioner's behalf in making the investments. Also, Loria told petitioner that he

could invest petitioner's funds in short-term construction loans in Costa Rica until the funds were needed for anticipated real estate investments in late 1975. Petitioner was receptive to the idea. Shortly thereafter, he returned to Arizona.

In March 1974, Loria arranged for the formation of a Costa Rican corporation by the name of Inversiones Para El Progreso Sociedad Anonima (IPSA). As explained by Loria to petitioner, petitioner would own 100 percent of the stock, petitioner would be president, petitioner's brother would be vice-president, and Loria would be secretary. Also, Loria would have full authority to act for IPSA, to control its assets, and to write checks on its bank accounts. Only ten shares of bearer stock were issued, and at least one stock certificate dated March 14, 1974, included petitioner's signature on a line marked "President."

Shortly after IPSA was formed and unbeknownst to petitioner, Loria formed three other corporations, Trimiran, S.A., Den Haag, S.A., and Finca Alsina, S.A. The ownership of these corporations was also in the form of bearer stock.

In December 1974, petitioner returned to Costa Rica. He purchased a new vehicle, a Range Rover, and opened two IPSA bank accounts with Banco Anglo Costarricense. One account would be maintained in Costa Rican colones and the other account would be maintained in United States dollars (Banco Anglo Colones Account and Banco Anglo Dollar Account, respectively, and Banco Anglo Accounts, collectively). At all relevant times in 1974, 1975, and 1976, the official exchange rate for Costa Rican colones was

8.54 colones for 1 dollar. The following table summarizes petitioner's deposits in the Banco Anglo Accounts through December 31, 1975:

Deposits to Banco
Anglo Dollar Account

<u>Date</u>	<u>Dollar Amount</u>	<u>Colones Equivalent</u>
Dec. 23, 1974	\$ 350.00	¢ 2,989.00
Jan. 3, 1975	450,000.00	3,843,000.00
Apr. 1, 1975	1,808,000.00	15,440,320.00
Nov. 14, 1975	<u>170,000.00</u>	<u>1,451,800.00</u>
Total	\$2,428,350.00	¢20,738,109.00

Deposits to Banco
Anglo Colones Account

<u>Date</u>	<u>Colones Amount</u>	<u>Dollar Equivalent</u>
Dec. 19, 1974	¢251,000.00	\$29,391.10
Dec. 23, 1974	<u>147,009.08</u>	<u>17,214.18</u>
Total	¢398,009.08	\$46,605.28

The total of these deposits, some of which were wired from the United States, was \$2,474,955.28. From December 19, 1974, until July 23, 1975, only Loria wrote checks on the Banco Anglo Accounts.

Loria Purchases

In December 1974, petitioner and Loria arranged for IPSA to purchase a parcel of property known as Finca La Macha (Finca). Loria told petitioner that the purchase price was \$175,000, with \$75,000 to be withheld pending the seller's fulfillment of certain obligations. Loria completed the purchase on January 15,

1975. The deed was in Spanish and designated IPSA as the purchaser. It reflected a total cost of \$110,000; however, Loria withdrew \$182,000 from the Banco Anglo Dollar Account (January 17, 1975) and subsequently deposited \$69,018.50 in the Banco Anglo Colones Account (January 20, 1975).

In May 1975, Loria purchased for IPSA certain real property including a house and an adjoining parcel of undeveloped property. The check used to purchase the house was drawn on a bank account belonging to Trimiran, S.A.; however, title was taken in IPSA's name. The total cost of the house and undeveloped land was \$59,499.81. Loria gave petitioner a deed describing, in Spanish, only a portion of the property purchased. That property was sold on December 20, 1976, in exchange for cash and improved property which included a residence since used by IPSA as rental property.

Loria Loans

Regarding the loans to be arranged by Loria, petitioner was told in January 1975 that the interest would be approximately 30 percent and that all attorneys' fees would be paid by the borrowers. Subsequently, a number of loans were made by Loria with IPSA funds in March and April 1975. All of these loans matured in 1976, exactly 1 year from their respective dates of execution. The total of the principal amounts due on the loans was \$317,915.69, and each note stated its total amount payable to IPSA upon maturity. Interest varied between 18 and 24 percent,

and Loria's commission was 5 percent per loan. Both the interest and Loria's commission were deducted from the amount actually transferred to a borrower when his loan was made.

Investigation of Loria

Petitioner returned to Costa Rica in June 1975. He then discovered that his Range Rover, which was left in Loria's care, had been subject to substantial use and damage; further, many parts on the vehicle had been exchanged for worn replacements. As a result, petitioner became suspicious of Loria's management of the funds petitioner had transferred to the IPSA bank accounts. Petitioner asked Loria the status of those funds, but Loria avoided meeting with petitioner. After several weeks, Loria informed petitioner that he (Loria) would provide no information, would return no money, and could beat petitioner in court. In July 1975, after reviewing financial statements prepared by an accountant, petitioner conducted his own investigation of Loria's transactions. As a result of this investigation, petitioner discovered (1) transfers of funds from the Banco Anglo Dollar Account to the Banco Anglo Colones Account; (2) the existence of the three other corporations formed by Loria: Trimiran, S.A., Den Haag, S.A., and Finca Alsina, S.A.; (3) transfers of funds totaling \$1,296,491.14 from IPSA to Trimiran, S.A. in April and May 1975; and (4) many short-term loans executed by the three other corporations between March and July 1975. The total face amount of these loans was

\$1,174,473.05, including loans due in 1975 with a face amount of \$70,257.60.

Petitioner hired a Costa Rican attorney, Carballo, to assist in obtaining a proper accounting from Loria. After meeting with Loria, Carballo advised petitioner that Loria was willing to turn over to petitioner the bearer stock in all four corporations. Petitioner agreed to accept the stock but only to mitigate his damages, and Loria signed a written statement to that effect. Carballo also persuaded Loria to return certain funds to IPSA. Accordingly, in or about July and August 1975, Loria deposited a total of \$715,137.92 in the Banco Anglo Colones Account and delivered to petitioner, for the first time, all of the bearer stock to the four corporations, IPSA, Trimiran, S.A., Den Haag, S.A., and Finca Alsina, S.A. In July 1975, petitioner fired Loria as his attorney and property manager.

The minute book for IPSA included the following entries: The first entry, dated December 17, 1974, described Loria and another individual, Osborne, as the owners of all the IPSA stock and described Loria as secretary; the second entry, also dated December 17, 1974, described the resignation of the president (unnamed) and described Osborne as the new president; the third entry, dated December 18, 1974, stated that all members were present at a meeting that date and that the prior appointment of Osborne as president was nullified in view of the transfer of stock to petitioner. None of those entries indicate petitioner's presence or approval, and the next recorded shareholders' meeting

was not until August 18, 1975. The entry recorded on that date described petitioner as present and in possession of the IPSA stock and described Loria's resignation.

Kanes

In late July 1975, petitioner retained the services of Levi Kanes (Kanes) to continue with petitioner's plan to reinvest the proceeds remaining from the sale of the Tucson Property in Costa Rican properties. Kanes was made an officer of IPSA with unlimited authority. Kanes opened an IPSA bank account at Banco de Costa Rica in which petitioner deposited 4,500,000 colones (from the funds returned by Loria). In November 1975, petitioner also deposited \$170,000.00 in the Banco Anglo Dollar Account.

Subsequently, petitioner or Kanes purchased for IPSA certain parcels of real property. The dates and prices of these purchases were as follows:

<u>Date</u>	<u>Purchase Price</u>	<u>Purchasing Agent</u>
August 22, 1975	376,212 colones (\$44,052.93)	Petitioner
September 1975	251,345 colones (\$29,431.50)	Petitioner
November 4, 1975	\$250,000	Kanes
Late 1975	\$5,035.13	Petitioner
Late 1975	500,000 colones (\$58,548)	Petitioner

The total cost of these purchases was \$387,067.56. For each purchase, title was taken in IPSA's name, and each deed was written in Spanish.

As with Loria, petitioner began to suspect Kanes of misappropriating IPSA funds. As a result of an investigation commenced in late 1975 but on uncertain dates, petitioner discovered that Kanes had been selling cattle and keeping the money, had been writing checks on the IPSA bank account payable to himself, and had borrowed against a \$526,932 (4,500,000 colones) Certificate of Deposit held by IPSA for 100 percent of its value. Some time after January 1976, petitioner removed Kanes as an officer of IPSA.

Additional Recovery Efforts

Petitioner and his attorney, Carballo, attempted to recover the funds that had been loaned by Loria, and between 1976 and 1978, they foreclosed on property securing four of the loans.

In December 1976 petitioner brought suits in Costa Rica against Loria and Kanes. The suit against Loria was dismissed in February 1977, and Loria filed a countersuit against petitioner. Because Kanes left Costa Rica and was not subjected to jurisdiction in its courts, the suit against him was pending at the time of the trial of this case in 1985.

Notice of Deficiency

On his 1973 tax return, petitioner reported an election to postpone tax on the gain of \$3,686,231.08 resulting from the sale

in 1973 of the Tucson Property, with the intent to purchase replacement property qualifying for nonrecognition of gain. On schedule C of his 1975 tax return, petitioner reported, without further explanation, "Losses incurred in Costa Rica by misappropriation of funds by agents" in the amount of \$1,676,475.96. In December 1976, petitioner filed an amended 1973 tax return to report the gain on the sale of the Tucson Property and the nonrecognition of a portion of that gain to the extent he purchased claimed replacement properties in the amount of \$817,214.53. Petitioner included in the amended return a statement requesting that the assessment of his resulting 1973 tax be abated until a determination was reached regarding his application for a 1975 net operating loss (NOL) and carryback. That application was made on a Form 1045, Application for Tentative Refund, filed with petitioner's amended 1973 return or shortly thereafter. Therein, petitioner reported his NOL for 1975 of \$1,476,471.12 and the carryback of that NOL to 1973 and to 1972 for a reduction in his tax liability in each of those years.

In his notice of deficiency, respondent disallowed a portion of the nonrecognition of gain claimed by petitioner in his amended 1973 tax return on the ground that petitioner had not established that he acquired more than \$5,528.60 of replacement property. Respondent also disallowed the claimed 1975 NOL and the carryback of that NOL to taxable years 1973 and 1972 on the ground that petitioner had not established that the alleged Costa

Rican loss reported on Schedule C of petitioner's 1975 tax return was an ordinary and necessary business expense or that it was expended for the purpose so designated.

OPINION

Replacement Property

Respondent concedes in his brief that petitioner is entitled to nonrecognition of gain under section 1033 to the extent of the United States properties purchased by petitioner for the purpose of replacing the Tucson property, which he sold in 1973 under the threat of condemnation. What remains for our determination is whether petitioner is also entitled to nonrecognition of gain under section 1033 to the extent of the Costa Rican properties purchased in 1974 and 1975 by IPSA, petitioner's newly formed Costa Rican corporation.

Section 1033 provides in pertinent part as follows:

SEC. 1033. INVOLUNTARY CONVERSIONS.

(a) General Rule.--If property (as a result of its * * * condemnation or threat or imminence thereof) is compulsorily or involuntarily converted--

* * *

(3) Conversion into money where disposition occurred after 1950.--Into money * * * the gain (if any) shall be recognized except to the extent hereinafter provided in this paragraph:

(A) Nonrecognition of gain.--If the taxpayer during the period specified in subparagraph (B), for the purpose of replacing the property so converted, purchases other property similar or related in service or use to the property so

converted, or purchases stock in the acquisition of control of a corporation owning such other property, at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized upon such conversion * * * exceeds the cost of such other property or such stock. Such election shall be made at such time and in such manner as the Secretary or his delegate may by regulations prescribe. * * * [Emphasis supplied.]

Respondent does not contest the validity or timeliness of petitioner's election under section 1033 or the timeliness of the Costa Rican purchases under section 1033(a)(3)(B). Also, respondent concedes in his brief that the Costa Rican properties were similar or related in service or use to the Tucson property. Respondent argues, however, that the Costa Rican properties do not qualify under section 1033 because they were purchased by petitioner's corporation, IPSA, and not by petitioner. See Hill v. Commissioner, 66 T.C. 701, 704 (1976); and Feinberg v. Commissioner, 45 T.C. 635, 639 (1966), affd. 377 F.2d 21 (8th Cir. 1967).

Petitioner argues that his use of a corporation qualifies under section 1033 as construed by this Court in John Richard Corp. v. Commissioner, 46 T.C. 41 (1966). Alternatively, petitioner argues that the corporation, IPSA, should be disregarded because petitioner was misled by his Costa Rican attorney to believe that the corporation was necessary to make any purchases of Costa Rican property and that therefore he should be treated as the purchaser of the replacement property.

In John Richard Corp. v. Commissioner, supra, we held that the taxpayer's purchase of controlling stock in a new corporation that subsequently purchased replacement property "was the purchase of stock 'in the acquisition of control of a corporation owning' similar property within the meaning of the statute." 46 T.C. at 45. In that case, the taxpayer corporation's wool-processing plant was destroyed, and for business reasons, the taxpayer created a new corporation for the purpose of purchasing and operating a new wool-processing plant. The taxpayer purchased 99 percent of the new corporation's stock, and, shortly thereafter, the new corporation acquired a mill, thereby resuming the wool-processing business previously conducted. We found that the new plant was similar to the prior plant. Thus, the sole remaining issue was whether the taxpayer's purchase of controlling stock in a newly formed corporation that subsequently acquired similar property qualified the taxpayer for nonrecognition of gain under section 1033.

Respondent's primary argument in John Richard Corp. was that section 1033, applied literally, did not extend to the taxpayer because the new corporation did not own the replacement property at the time the taxpayer acquired its controlling stock interest. On those facts, however, we applied a liberal construction of section 1033 and concluded for the following reasons that it was immaterial that the mill was acquired after the taxpayer purchased the stock:

The entire transaction, including the location of and negotiations for the new mill occurred within a period of 1 month. The acquisition of the stock and the purchase of the mill occurred within a few hours, if not actually at the same time and place. Petitioner's purchase of the stock and the acquisition of the mill by Peterborough Mills were separated in point of time only so far as was required by business practicalities. Any distinction in the application of the statute under these circumstances and in the case of a purchase of stock in a corporation which previously owned the property is too technical to be justified and would fail to give effect to the statutory purpose to allow tax-free replacement of involuntarily converted property through the purchase of other property or stock. [46 T.C. at 47.]

Thus, because the organization of the new corporation, the acquisition of its stock, and the purchase of the mill were "merely steps in an integrated transaction having for its purpose the replacement of petitioner's involuntarily converted property," we held that the taxpayer was entitled to nonrecognition of gain under section 1033(a)(3)(A). 46 T.C. at 47. See also Clifton Investment Co. v. Commissioner, 36 T.C. 569, 573 (1961), affd. 312 F.2d 719 (6th Cir. 1963).

Petitioner argues that the facts here compel a similar conclusion to that in John Richard Corp. v. Commissioner, *supra*, i.e., that the formation and use of IPSA was merely an integral step in petitioner's plan to reinvest condemnation proceeds in replacement property. Although petitioner's intent in forming IPSA may have been similar to the taxpayer's intent in forming a new corporation in John Richard Corp., other facts distinguish this case from John Richard Corp.

In John Richard Corp., the taxpayer's newly formed corporation purchased only similar property. Other cases, where stock purchases were held to qualify under section 1033, do not indicate that the acquired corporations owned any property other than similar property. See, generally, Broadview Lumber Co. v. Commissioner, 561 F.2d 698 (7th Cir. 1977); Gaynor News Co. v. Commissioner, 22 T.C. 1172 (1954); Kimbell-Diamond Milling Co. v. Commissioner, 10 T.C. 7 (1948). Where a corporation's principal assets were not similar property, a stock purchase did not qualify under section 1033, even though some of the assets were similar. Templeton v. Commissioner, 66 T.C. 509 (1976), supplemental opinion 67 T.C. 518 (1976), affd. per curiam 573 F.2d 866 (4th Cir. 1978). In Templeton, we stated that a stock purchase would not qualify unless the corporation's "assets consist principally of similar property." 67 T.C. at 521. Here, petitioner may have originally intended that IPSA acquire assets consisting principally of similar property, but that is not what transpired.

In 1974 and 1975, petitioner transferred to IPSA proceeds exceeding \$2.4 million, yet less than 25 percent of those funds were expended in purchasing similar property. Most of the remaining funds were invested in short term lending operations conducted by IPSA and other corporations organized by petitioner's agent, Loria. Thus, because the proceeds advanced to IPSA were not invested in assets consisting principally of similar property, we conclude that petitioner did not purchase

stock in the acquisition of control of a corporation owning similar property within the meaning of section 1033.

Petitioner argues that if we do not apply John Richard Corp., he should be treated as the owner of the property and should qualify under section 1033 as having purchased similar property himself. Petitioner contends that IPSA should be disregarded because it was used by Loria and Kanes to perpetrate a fraud against him. To support this argument, petitioner cites certain cases for the proposition that State law ignores corporate form if that form sanctions fraud or promotes injustice. Employer's Liability Assurance Corp. v. Lunt, 82 Ariz. 320, 313 P.2d 393, 395-396 (1957); Stark v. Coker, 20 Cal. 2d 839, 129 P.2d 390, 394-395 (1942). As respondent correctly points out, however, these cases are distinguishable. They applied the equitable "alter ego doctrine" to enable third party creditors to pierce the corporate veil and hold the owners of the respective corporations personally liable.

Petitioner argues that this equitable theory may also be extended for the benefit of stockholders. Conway v. Citrus Belt Land Co., 94 Cal. App. 533, 538, 271 P. 525 (1928). Conway, however, was not a tax related dispute and only recognized that the equitable doctrine may apply "where the rights of stockholders among themselves were presented for the consideration of the court." 271 P. at 527. Emphasis supplied.

Corporate form will not be disregarded to facilitate tax avoidance. Moline Properties, Inc. v. Commissioner, 319 U.S. 436

(1943). See also Western States Bankcard Associations v. San Francisco, 19 Cal.3d 208, 561 P.2d 273 (1977). "[I]n matters relating to the revenue, the corporate form may be disregarded where it is a sham or unreal." Moline Properties, Inc. v. Commissioner, 319 U.S. at 439. Petitioner, however, has not proven such circumstances. IPSA conducted more than one business activity, had corporate officers, maintained records and bank accounts separate from and independent of petitioner, and, as in Moline Properties, Inc., petitioner's control, during most of the period in issue, over specific corporate activities was negligible. Furthermore, petitioner had the opportunity to take "corrective" action but did not do so. For instance, petitioner testified that he believed the corporation was buying property in his name, yet even after removing his first agent Loria, he purchased property for IPSA in IPSA's name. Also, before the section 1033(a)(3)(B) period had expired, petitioner was aware that a substantial portion of the funds had not been spent on similar property; yet, petitioner took no course of action to conform the purchases to the requirements of section 1033. Petitioner cannot simply pick and choose corporate items to be reported on his individual tax return.

Thus, petitioner is not entitled to nonrecognition of gain on the sale of the Tucson Property to the extent that proceeds were reinvested by or through IPSA.

Theft Loss

Section 165 allows a deduction for loss from theft discovered during the taxable year to the extent that such loss exceeds \$100 and is not reimbursed by insurance or otherwise. To be allowable as a deduction, the loss must be bona fide, evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the taxable year. Section 1.165-1(b), Income Tax Regs. Petitioner bears the burden of proving that he is entitled to the claimed theft loss deduction. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a), Tax Court Rules of Practice and Procedure.

Petitioner argues that he incurred a deductible theft loss of \$1,676,475.96 in 1975 as a result of the fraudulent misappropriation of funds by Loria and Kaness. Petitioner alleges that he owned the property at the time of the loss, the loss constituted a theft under applicable State and Federal law,² the loss was discovered in 1975, and there was no reasonable prospect for additional recovery of property. In his reply brief, petitioner computes his theft loss attributable to Loria as follows:

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A taxpayer must establish that an alleged loss constitutes a theft under applicable local law. Paine v. Commissioner, 63 T.C. 736, 740 (1975), affd. without published opinion 523 F.2d 1053 (5th Cir. 1975). Although the parties dispute which jurisdiction applies, they agree that the laws of the jurisdictions they each seek to apply are similar in defining theft. See for instance Ariz. Rev. Stat. Ann. sections 13-681, 13-682 (repealed 1978); Cal. Penal Code sections 484, 503 (West 1970); Costa Rican Penal Code, Title VII, sec. IV, art. 216 (1975).

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<u>Item</u>	<u>Value</u>
Real property purchased for IPSA	\$ 169,500.00
Loans	168,029.86
Loria payment	715,137.00
IPSA Banco Anglo Dollar Account	18,094.00
IPSA Banco Anglo Colones Account	178.00
Trimiran Bank Account	<u>-0-</u>
Total Value of recovered property	1,070,938.86
Amount transferred to Costa Rica	<u>(2,304,955.00)</u>
Loss as of 7-31-75	(1,234,016.04)

Petitioner then states categorically that the balance of the total loss claimed on his tax return was attributable to Kanes.³

After carefully examining the evidence,⁴ we conclude that petitioner has failed to prove that he incurred a deductible theft loss in 1975. As explained in more detail below, petitioner failed to establish that he owned the property allegedly stolen, that he discovered in 1975 the alleged losses related to Kanes, that the amount of any loss was not "otherwise"

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First, petitioner, in his 1975 tax return, reports a loss of \$1,676,475.96, without any explanation. Second, petitioner, in his opening brief, calculates the alleged loss as the difference between the total funds transferred to Costa Rica in 1975 (\$2,474,955.28) and the "value" of the property recovered (\$734,375.67), which petitioner asserted was composed of (1) Loria purchases of \$169,499.81, (2) Kanes purchases of \$387,067.56, (3) bank balances of \$9,778.44, and (4) Loria's loans "valued" at \$168,029.86. Third, petitioner, in his reply brief, calculates the alleged loss as set forth in the text above. No reconciliation is attempted.

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Of the 63 exhibits admitted into evidence, 43 were written in Spanish, and no English translation was provided.

compensated, and that no reasonable prospect of recovery existed at the end of 1975.

A theft loss deduction may be claimed only by the taxpayer who owned the property at the time it was taken. Mannette v. Commissioner, 69 T.C. 990, 994 (1978); Rink v. Commissioner, 51 T.C. 746, 753 (1969).⁵ Respondent argues that IPSA was the owner of the property at the time it was allegedly stolen and that therefore any deductible theft loss was IPSA's not petitioner's.

Petitioner claims that he is nevertheless entitled to the alleged theft loss deduction under the rule developed in Vietzke v. Commissioner, 37 T.C. 504 (1961), wherein we held that the individual taxpayer could claim a loss for money advanced to a corporation and subsequently stolen. In that case, a life insurance corporation was being organized by two individuals when the taxpayer was enticed to invest in the venture. The taxpayer advanced a total of \$25,000 for stock subscriptions. The money was placed in a trust account and subsequently used for personal expenses of the two organizers. We determined that the corporate entity was merely a device used to swindle subscribers, and the corporation never reached the level of operating an insurance business, its intended purpose.

Respondent argues that Vietzke is distinguishable from the facts herein. We agree. Although IPSA was formed only upon Loria's recommendation, it nevertheless operated as a vehicle for

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See also Jensen v. Commissioner, T.C. Memo. 1979-379.

making loans and purchasing property. Petitioner signed organizational documents; he granted Loria and later Kanes broad control over assets and funds; and he transferred substantial sums of money to IPSA. Although there may indeed have been the mishandling and misappropriation of funds, IPSA was not merely a swindler's "device," as was the case in Vietzke.⁶

Petitioner also argues that State law ignores corporate form if that form sanctions fraud or promotes injustice. Employer's Liability Assurance Corp. v. Lunt, 82 Ariz. 320, 313 P.2d 393, 396 (1957); Stark v. Coker, 20 Cal. 2d 839, 129 P.2d 390 (1942). We have already addressed this contention with regard to petitioner's replacement property, and as we stated there, petitioner has not satisfied us that, in view of petitioner's facts, the corporate form should be disregarded.

A theft loss may be claimed only in the year in which it is discovered. Section 165(e); section 1.165-1(d)(1), Income Tax Regs.; Asphalt Industries, Inc. v. Commissioner, 411 F.2d 13 (3d Cir. 1969), affg. a Memorandum Opinion of this Court. The evidence shows that petitioner discovered mishandling of IPSA's funds by Loria in 1975; petitioner became suspicious, conducted an investigation, and fired Loria in or about July 1975. Petitioner has not proven, however, that he made such a discovery in 1975 with regard to Kanes. The record indicates that (1) Kanes was hired in July 1975, (2) an investigation was

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See Silverman v. Commissioner, T.C. Memo. 1975-255, affd. without published opinion 538 F.2d 320 (3d Cir. 1976).

commenced in late 1975, (3) funds were transferred to the Banco Anglo Accounts in November 1975, (4) Kanes continued to write checks on IPSA accounts in 1976, and (5) Kanes was fired after January 1976. Petitioner concedes on brief that at least some of Kanes' acts were not discovered in 1975; however, he offers no substantiation as to what was discovered in 1975 and what was discovered in 1976. Had petitioner discovered a theft in 1975, it is doubtful that he would have continued Kanes' services until after January 1976. Petitioner has failed to prove any discovery in 1975 of theft by Kanes.

Section 165(a) allows a deduction only for a loss "not compensated for by insurance or otherwise." Based on our examination of the record, we conclude that petitioner has also failed to prove that he sustained a loss in 1975 net of the amounts reimbursed by Loria. Petitioner recovered from Loria the bearer stock in the four corporations and cash of \$715,137. Although petitioner recognizes this in his reply brief, his calculation of the amounts reimbursed uses an unreasonably small value for the short-term loans, which had a face amount totaling almost 10 times the value asserted by petitioner.

Finally, petitioner has failed to prove that there was not at the end of 1975 a reasonable prospect for recovery of any loss sustained by him. Section 1.165-1(d)(2)(i) provides as follows:

(2)(i) If a casualty or other event occurs which may result in a loss and, in the year of such casualty or event, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which

reimbursement may be received is sustained, for purposes of section 165, until it can be ascertained with reasonable certainty whether or not such reimbursement will be received. Whether a reasonable prospect of recovery exists with respect to a claim for reimbursement of a loss is a question of fact to be determined upon an examination of all facts and circumstances. * * *

"A reasonable prospect of recovery exists when the taxpayer has bona fide claims for recoupment from third parties or otherwise, and when there is a substantial possibility that such claims will be decided in his favor." Ramsay Scarlett & Co. v. Commissioner, 61 T.C. 795, 811 (1974), affd. 521 F.2d 786 (4th Cir. 1975), and cases cited therein. This determination requires an objective analysis of the reasonable expectations that existed at the close of the taxable year. Ramsay Scarlett & Co., supra at 811.

At the close of 1975, petitioner had only begun his investigation of Kanes, had not yet discovered any Kanes-related misappropriations, and still employed Kanes. Petitioner discovered Loria's misappropriations and fired Loria in 1975. Loria, however, gave petitioner the bearer stock of the corporations and \$715,137.92 in 1975. The corporations continued to hold the property purchased as well as the short-term notes, most of which were due in 1976. Even if petitioner had not recovered by the end of 1975 all of his loss attributable to Loria, he has not proven that there was no reasonable prospect of recovery.

For all of the above reasons, respondent's disallowance of the theft loss deduction must be sustained.

Because of concessions by the parties,

Decision will be entered
under Rule 155.

Jul 11.7/2: 1986-241

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UNITED STATES TAX COURT

ALAN BRECK AND LUCINDA BRECK, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 12315-80.

Filed June 16, 1986.

Alan Breck and Lucinda Breck, pro se.

Jeffrey N. Kelm, for the respondent.

MEMORANDUM FINDINGS OF
FACT AND OPINION

KÖRNER, Judge: Respondent determined a deficiency in Federal income tax against petitioners in the amount of \$1,670 for their taxable year ended December 31, 1976.

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The issues presented for decision are: (1) Whether petitioners are entitled to a claimed loss representing their distributive share of the losses of West Texas Company, a California limited partnership, for the year in issue; and (2) whether petitioners are entitled to a deduction in the amount of \$1,867, representing payments made by them to the partnership during 1976.^{1/}

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulations of fact and exhibits attached thereto are incorporated herein by this reference.

Alan Breck ("Alan" or "petitioner") and Lucinda Breck ("Lucinda") were husband and wife and residents of Wills Canyon, Cloudcroft, New Mexico, at the time the petition herein was filed. Petitioners timely filed a joint Federal income tax return for their taxable year 1976, using the cash receipts and disbursements method of accounting. During the year in issue, Alan was a practicing physician and Lucinda was a fashion consultant.

^{1/} This issue was not raised by the pleadings, but in petitioners' initial brief. Respondent, however, agrees that this Court should decide this issue and addressed it in his reply brief. This issue is, therefore, properly before this Court. Rule 41(b), Tax Court Rules of Practice and Procedure.

Background of Persons and Companies Involved

In 1972, Al Landry, Michael Betterton, and other individuals founded American Film Brokers ("AFB"), a California corporation. From AFB's inception, Landry was its president. Betterton served as AFB's vice president and chief financial officer from 1972 until 1976.

Prior to 1972, Landry and Betterton had each invested in a motion picture, and Landry had organized a nonprofit company to help various civic organizations raise funds by showing films. Landry and Betterton had no other experience in the movie industry.

Raymond Axelrod, though not a founding member, also joined AFB in 1972. Axelrod had extensive experience in the film industry, having been previously employed in managerial capacities by Warner Brothers, United Artists, Eagle Lion, and Allied Artists.

American Films Brokers Operations

Generally, AFB would acquire films that the major or large independent distributors had declined to distribute. The films AFB acquired would generally be obtained from the producers under contracts calling for cash or other consideration -- such as payment of the producer's outstanding film laboratory bills -- as a down payment, and percentage payments out of future distribution income. In such deals, the primary area of negotiation with the producers would be the amount of the down payment. AFB

always tried to purchase the film for the lowest amount of cash possible and to have the producer take most of his consideration in the form of a percentage of the income to be generated by the distribution of the film.

Generally, Betterton would conduct AFB's negotiations with the film producers. AFB usually did not seek Axelrod's advice regarding the maximum down payment that AFB should pay for the films it acquired. Axelrod's duties in connection with AFB's film acquisitions were confined to viewing the pictures, judging their suitability within AFB's program, and informing Betterton or Landry that he had located potentially suitable films. Betterton and/or Landry, not Axelrod, would decide which films AFB would acquire. After AFB had acquired a film, Axelrod managed its marketing and distribution.

AFB would resell its films to investors, usually limited partnerships. The resales to partnerships normally provided for a cash down payment and principal and interest payments for seven years, with the balance of a promissory note due and payable in 10 years. A warranty agreement allowed the investors to return the film in lieu of payment of the note. The resale transactions were always structured so that the cash consideration received by AFB from investors would exceed the cash AFB had paid to the producers. Each resale transaction to an investor partnership was accompanied by a film distribution agreement between AFB and the partnership, pursuant to the terms of which AFB was engaged to distribute the film. The investors could change the

distributor only by paying the full contract amount for the film. It was AFB's intention to retain control of the film in that way. Due to the passage of the Tax Reform Act of 1976, AFB phased out this program in 1976.

History of the Film "West Texas 1870"

In 1970, Alan Gadney released his first motion picture titled West Texas 1870 (sometimes referred to as "the film"). The film was written and directed by Gadney, and took three years to produce, although the film was not in continuous production for three years. At the time that the film was made, Gadney was a graduate student at the University of Southern California. The film was financed through two scholarships, from the Academy of Motion Picture Arts and Sciences and the Directors Guild of America, and an out-of-pocket investment of \$5,000. Approximately 50 students worked on the film, which was submitted to the university as Gadney's thesis film. The film was 55-minutes in length. It won numerous awards, including the Cannes Amateur International Film Festival, the Atlanta Film Festival, and the San Sebastian Film Festival, but was poorly received in commercial markets and was not widely shown.

The story of West Texas 1870 consisted of the flashback remembrances of an old woman in 1920, back to the days when she was a young girl on the West Texas frontier. The film was

reviewed by Hollywood Reporter on March 6, 1970, and by Variety on March 18, 1970. According to John Mahoney, of Hollywood Reporter, the film:

is more impressive for the effort that is evident on the screen than the product of that effort. Though 55 minutes in length, it is no more than a short story of character, stretched and surprisingly conventional, marred by moments of hand-held camera wooziness and a frequently overproduced track. It is a perfectly respectable thesis film, but unlike a number of short films to come from the department in recent years, it has virtually no commercial interest or potential.

Variety's Rick Setlowe found that the film:

Like Miss Porter's stories, is quite interesting in a dull sort of way, lethargically paced as a mid-summer afternoon, and carefully crafted, even slick. But the characters are vivid and memorable. * * * Although its commercial prospects are very limited, "West Texas" is a professional effort in which student Gadney has creatively transformed limitations into assets and originality. It ranks with "Aymonn the Terrible," which Francis Ford Coppola did when at UCLA, as an outstanding example of what can be produced at the student level.

West Texas Company

West Texas Company ("WTC") was organized as a limited partnership under the California Uniform Partnership Act, on or about May 31, 1973. According to the certificate of limited partnership, WTC was formed for the stated purpose of acquiring a motion picture titled West Texas for ultimate distribution and/or resale.

The limited partnership agreement provided that profits and losses were to be allocated according to the limited partner's respective percentage in WTC. It also provided that the general partner was to be solely responsible for the management of WTC's business, with all the rights and powers generally conferred by law and necessary, advisable, or consistent therewith. The general partner was authorized, inter alia: (1) To expend WTC's capital and income; (2) to acquire, lease, distribute, manage, and dispose of any motion picture; and (3) to enter into an agreement with AFB or any other entity for the leasing, distribution, discounting, development, improvement, maintenance, exchange, trade, or sale of WTC's property at such price as he, in his absolute discretion, deemed to be in WTC's best interest. The agreement further provided that the limited partners were not to participate in the management, conduct, or control of the partnership business and did not have the right or authority to act for or to bind the partnership.

WTC's general partner was Jurg Frey, M.D. In addition to the general partner, WTC had nine limited partners, of which petitioner was one.

Prior to his becoming a limited partner of WTC, Alan received and studied a 30-page tax opinion, prepared by the law firm of Elisberg & Prager at AFB's request, and distributed by AFB to potential investors, explaining the Federal income tax consequences of the acquisition of a motion picture by a limited

partnership. The tax opinion contained a summary of worst conditions, detailing the Federal income tax consequences to a married investor with a \$34,000 average taxable income as follows:

<u>Year</u>	<u>Cash Outlay</u>	<u>Tax Deduction</u>	<u>Tax Savings</u>	<u>Difference (+)</u>
1973	\$ 7,489	\$17,364 plus \$3,115 Investment Tax Credit (415%)	\$10,819	\$3,330 (+)
1974	3,844	8,549 (222%)	4,217	373 (+)
1975	3,244	7,178 (221%)	3,600	356 (+)
1976	2,694	6,091 (226%)	3,074	380 (+)
1977	2,169	5,237 (241%)	2,656	487 (+)
1978	2,034	4,553 (224%)	2,321	287 (+)
1979	2,028	4,557 (225%)	2,323	295 (+)
	<u>\$23,502</u>	<u>2/\$53,801 + 3,115</u> <u>I.T.C. (286%)</u>	<u>\$29,010</u>	<u>\$5,508 (+)</u>

Petitioners read newspaper and magazine articles, an offering memorandum from AFB, a promotional package from AFB -- containing some undated reviews, none of which referred to the commercial prospects of the film -- and viewed the film prior to its purchase (see infra).

Alan became a limited partner of WTC on May 31, 1973, with a partnership share of ten percent. Alan's stated contribution to the partnership was \$37,500, payable as follows: (1) a \$2,500 cash contribution; and (2) a nonnegotiable promissory note payable to WTC dated April 6, 1973, in the principal amount of \$35,000, providing for the payment of interest at an annual rate of 5 percent from April 6, 1973. The cash was paid and the note executed in April 1973. Interest on the note was to be payable on December 15 of each year, commencing on December 15, 1973.

2/ The mathematical addition is incorrect. The correct total amount is \$53,529 + 3,115 I.T.C.

Payments of principal were to be made on June 30 of each year, beginning with June 30, 1974. The schedule of payments to be made on the note was as follows:

	<u>Management Fee (June 30)</u>	<u>Interest Dec. 15</u>	<u>Principal June 30</u>
1973	\$1,500	\$ 1,375	
1974		1,625	\$ 1,000
1975		1,587	500
1976		1,567	300
1977		1,555	200
1978		1,547	100
1979		1,542	100
1980			\$30,800
Total	<u>\$1,500</u>	<u>\$10,798</u>	<u>\$33,000</u> ^{3/}

The nonnegotiable promissory note provided that "All payments received on this note shall be credited first to interest then due and the remainder, if any, to principal."

Petitioners received a letter, dated March 1, 1976, from Betterton. The letter provided, in pertinent part, as follows:

Under the terms of the purchase contract on the Film, "West Texas," you will have quarterly payments in 1976 of \$466.75.^{4/} The first of these is now due and you should return your check in the amount of \$466.75, made payable to the West Texas Company, in the enclosed envelope.

Prompt remittance of these contractual payments will entitle you to a tax deduction of \$4,741 for 1976.

^{3/} The above schedule of payments, which was part of the note executed by Alan, adds up to only \$34,500, rather than the full note amount of \$35,000. The discrepancy is unexplained by the record.

^{4/} Neither the Agreement for the Purchase and Sale of a Motion Picture Film, dated May 31, 1973, between AFB and WTC, nor the \$350,000 nonnegotiable promissory installment note provided for quarterly payments. See infra.

Alan made principal and interest payments through the year in issue. In 1976, payments in the total amount of \$1,400.25 were made, as follows: \$466.75 each on March 1, 1976, May 29, 1976, and September 1, 1976.

Acquisition by AFB of West Texas 1870 and
AFB's contracts with WTC

On April 27, 1973, AFB and Gadney executed a document entitled Motion Picture Purchase and Sale Agreement. Pursuant to its terms, Gadney sold the original color negative of West Texas 1870, the internegative protection print, the composite release print of the film, all other related materials, and all of his right, title, and interest in and to the film, including distribution rights, to AFB.

The consideration paid for the above assets was as follows: (1) \$2,500 in cash; (2) a promissory note in the principal amount of \$7,500, providing for the payment of interest at an annual rate of 10 percent; principal payments on the note, in the minimum amount of \$1,000, were to be made each month, beginning on June 15, 1973, and interest was to be paid at the time of the final principal payment; (3) 60 percent of the net proceeds -- as defined in said agreement -- distributed to AFB by WTC until such time as Gadney had received the aggregate sum of \$40,000 (including the \$10,000 in (1) and (2) above); and (4) 25 percent

of any further net proceeds distributed by WTC to AFB. The said agreement further stated that Gadney acknowledged that AFB was purchasing the film for resale to WTC.

Both Landry and Betterton recommended that WTC purchase the film. Landry and Betterton were officers of AFB at the time they recommended the purchase of the film by WTC.

The negotiations for the purchase of the film were conducted on behalf of WTC by Frey, its general partner. From the outset, AFB stated that a \$350,000 purchase price and the amount of the cash down payment were not subject to negotiation. Frey did not inquire about the actual production costs of the film, nor did he consult with an attorney with regard to such matters as copyrights, protection of title, or title insurance. WTC did not obtain an outside appraisal of the film prior to its purchase.

On May 31, 1973, AFB, through Landry and Betterton, and Frey, on behalf of WTC, entered into an agreement for the sale of West Texas 1970. The agreement provided that the purchase price was \$350,000, payable as follows: (1) A \$25,000 cash down payment already paid; and (2) a nonnegotiable promissory installment note for balance of the purchase price, with interest from May 31, 1973, at an annual rate of 5 percent.

On the same day, Frey, on behalf of WTC, signed a nonnegotiable promissory installment note to AFB in the principal amount of \$350,000.^{5/} The note provided for principal and interest

^{5/} The discrepancy between the terms of the purchase and sale agreement and the nonnegotiable promissory note is unexplained by the record.

payments as follows:

	<u>Management Fee</u> <u>(June 30)</u>	<u>Principal</u> <u>(June 30)</u>	<u>Interest</u> <u>(Dec. 15)</u>
1973	\$15,000		\$ 9,625
1974		\$ 10,000	16,250
1975		5,000	15,870
1976		3,000	15,670
1977		2,000	15,550
1978		1,000	15,470
1979		1,000	15,420
1980		308,000	^{6/}
Totals	<u>\$15,000</u>	<u>\$330,000</u>	<u>\$103,855</u>

In addition to the foregoing payments of principal and interest on the promissory note, and not as a substitute or offset therefor, WTC was to pay AFB: (1) 50 percent of the net proceeds from the film, as therein defined; and (2) 50 percent of the proceeds received by WTC from any sale or refinancing of the film, reduced by the expenses of sale or refinancing.

Simultaneous with the sale agreement, AFB and WTC executed a film distribution agreement, under the terms of which AFB was engaged to distribute the film. The said agreement provided that WTC was to: (1) Pay AFB an initial management fee equal to \$1,500 per partner of WTC; (2) reimburse AFB for the actual costs of prints and advertising incurred by AFB limited to a maximum of \$50,000; (3) pay 10 percent of the gross proceeds as therein defined for its expenses in marketing, leasing, licensing, promoting, distributing, or otherwise dealing with the film, and

^{6/} The above schedule of payments, contained in the promissory note, made no provision for the payment of interest on the remaining principal balance of \$308,000 from December 15, 1979, to June 30, 1980.

for its administrative expenses; and (4) pay AFB 35 percent of gross proceeds at the time the promissory note was paid in full.

A letter of warranty was also executed on May 31, 1973, pursuant to the terms of which, should: (1) WTC make all prior scheduled payments; (2) WTC not terminate the distribution agreement; and (3) the film not generate sufficient revenues to pay the last scheduled principal payment in the amount of \$308,000, then AFB would accept the film and all rights to the film as payment.

After the sale by AFB to WTC, Axelrod, the general sales and distribution manager at AFB, managed the marketing and distribution of the film. In 1973, AFB hired Terence J. Kollman as national sales manager to promote West Texas 1870.

AFB represented to the investors that it had spent \$12,797.35 for the advertising, shipping, and promotion of the film between April 27, 1973, and December 31, 1977. It was also represented that the film earned \$6,213.47 during the said period.

WTC filed Forms 1065, U.S. Partnership Return of Income, with the Internal Revenue Service for its taxable years 1973 through 1976. WTC used the cash receipts and disbursements method of accounting. The following is a summary of the items reported on the said returns:^{1/}

^{1/} Except for depreciation, the record does not disclose income and expense figures for 1973 and 1974.

<u>Items</u>	<u>1975</u>	<u>1976</u>
Gross Receipts	\$ 52	\$ 1,291
Depreciation ^{8/}	(40,192)	(32,154) ^{9/}
Interest	(15,798)	(15,670)
Distribution Expenses	(48)	(1,280)
Miscellaneous	(23)	(12)
Total Gain or (Loss)	<u>(\$56,009)</u>	<u>(\$47,825)</u>

Petitioners claimed a loss in the amount of \$4,782, representing their distributive share of the loss claimed by WTC, on their Federal income tax return for their taxable year ended December 31, 1976.

In his notice of deficiency dated April 9, 1980, respondent disallowed the claimed loss on the grounds that:

(1) It has not been established that creation and operation of the partnership had economic substance or that the partnership engaged in any activity for profit; (2) The portion of the loss attributable to depreciation is disallowed because the partnership [sic] basis in depreciable property has not been established nor has it been established that the partnership could properly claim depreciation in 1976. Further, it has not been established that the method of depreciation used was proper or that it bore a proper relation to a decline in value of the assets; (3) The portion of the loss attributable to purported interest is disallowed because it has not been established that the claimed amount was paid or accrued in 1976 nor that it represents interest on valid indebtedness. Further, the method of accounting used by the partnership does not clearly reflect income; and (4) The part of the loss deduction attributable to other expenses is

^{8/} WTC claimed a depreciable basis in the film of \$350,000 and used the 200-percent declining balance method of computing depreciation over a 10-year useful life. Depreciation claimed for 1973 and 1974 was \$98,800 and \$50,240, respectively.

^{9/} The stipulation of the parties describes this amount as \$32,155. WTC's return for 1976 discloses, however, and we have found, that the amount claimed as depreciation in 1976 was \$32,154.

disallowed because such expenses have not been substantiated as ordinary and necessary business expenses or as incurred in the production of income.

OPINION

Issue 1: Claimed Deductions and Loss

The first issue for us to determine is the extent, if any, to which petitioners are entitled to deduct their distributive share of WTC's loss claimed for 1976. The determination of this issue depends upon whether WTC is entitled to claimed deductions for interest expense, depreciation, distribution expenses, and miscellaneous expenses.

Respondent argues that the claimed loss arose out of an activity "not engaged in for profit" within the meaning of section 183,^{10/} and that: (1) The limitations therein provided must be applied to the facts herein; and (2) the principal amount of the nonnegotiable promissory note given by WTC to AFB in connection with the purchase of the film is not includable in the film's basis for purposes of computing depreciation and interest expense deductions.

^{10/} All statutory references are to the Internal Revenue Code of 1954, as in effect in the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise noted.

Section 183(a) provides that deductions arising from an activity "not engaged in for profit" shall not be allowed, except as provided in section 183(b).^{11/} If the activity is not engaged in for profit, section 183(b) separates the claimed deductions into two groups: (1) Section 183(b)(1) allows only those deductions which are not dependent upon a profit motive, e.g.,

^{11/} Sec. 183 provided, in pertinent part, as follows, during the year in issue:

SEC. 183. ACTIVITIES NOT ENGAGED IN FOR PROFIT.

(a) General Rule.--In the case of an activity engaged in by an individual or an electing small business corporation (as defined in section 1371(b)), if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.

(b) Deductions Allowable.--In the case of an activity not engaged in for profit to which subsection (a) applies, there shall be allowed--

(1) the deductions which would be allowable under this chapter for the taxable year without regard to whether or not such activity is engaged in for profit, and

(2) a deduction equal to the amount of the deductions which would be allowable under this chapter for the taxable year only if such activity were engaged in for profit, but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1).

(c) Activity Not Engaged in for Profit Defined.--For purposes of this section, the term "activity not engaged in for profit" means any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212.

interest and taxes; and (2) section 183(b)(2) allows the balance of the deductions which would otherwise be permitted only if the activity was engaged in for profit, but only to the extent that the gross income derived from the activity exceeds the deductions allowed under section 183(b)(1).

By its terms, section 183 is not a disallowance provision, but becomes operative when the taxpayer is engaged in an activity in which he is not otherwise entitled to his claimed deductions under sections 162 or 212, viz, where the taxpayer is not engaged: (1) In a trade or business; or (2) in an activity for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income. Sec. 1.183-2(b), Income Tax Regs.; Brannen v. Commissioner, 78 T.C. 471 (1982), affd. 722 F.2d 695 (11th Cir. 1984).

Whether a partnership is engaged in a trade or business or in an activity for which deductions are allowable under section 212 is determined at the partnership level. Fox v. Commissioner, 80 T.C. 972 (1983), affd. without published opinion 742 F.2d 1441 (2d Cir. 1984), affd. sub nom. Barnard v. Commissioner, 731 F.2d 230 (4th Cir. 1984), affd. without published opinions sub nom. Hook v. Commissioner, Kratsa v. Commissioner, Leffel v. Commissioner, Rosenblatt v. Commissioner, Zemel v. Commissioner, 734 F.2d 5-9 (3d Cir. 1984); Siegel v. Commissioner, 78 T.C. 659 (1982); Brannen v. Commissioner, supra; Hager v. Commissioner, 76 T.C. 759 (1981).

The partnership must prove that it engaged in the activities in issue with an actual and honest profit objective. Rule 142(a); Dreicer v. Commissioner, 78 T.C. 642 (1982), affd. without opinion 702 F.2d 1205 (D.C. Cir. 1983). The inquiry turns on whether the primary purpose and intention of the partnership in engaging in the activity was to make a profit. Fox v. Commissioner, supra; Hager v. Commissioner, supra, and cases cited therein. As used in this context, "primary" means "of first importance" or "principally," Surloff v. Commissioner, 81 T.C. 210 (1983); Jefferson v. Commissioner, 50 T.C. 963 (1968), citing Malat v. Riddell, 383 U.S. 569, 572 (1966), and "profit" means economic profit, independent of tax savings. Surloff v. Commissioner, supra; Shapiro v. Commissioner, 40 T.C. 34 (1963). While a reasonable expectation of profit is not required, the taxpayer's profit objective must be bona fide. Bessenvey v. Commissioner, 45 T.C. 261 (1965), affd. 379 F.2d 252 (2d Cir. 1967), cert. denied 389 U.S. 931 (1967). The issue is one of fact to be resolved on the basis of all the surrounding facts and circumstances. Sec. 1.183-2(b) Income Tax Regs.; Fox v. Commissioner, supra; Golanty v. Commissioner, 72 T.C. 411 (1979), affd. without published opinion 647 F.2d 170 (9th Cir. 1981).

Partnerships present a special problem in applying section 183. "Partnerships are mere formal entities. Obviously, they do not have independent minds of their own." Fox v. Commissioner, 80 T.C. at 1007. In determining partnership intent, we look at

the actions taken by the general partner, his knowledge, conduct, expertise, and success in the particular field, as well as any other factor which he relied upon in making partnership decisions, where the management of the partnership's affairs was left to the general partner. See Finoli v. Commissioner, 86 T.C. ___ (No. 45, April 16, 1986); Siegel v. Commissioner, supra; Brannen v. Commissioner, supra; Hager v. Commissioner, supra.^{12/}

In determining whether an activity is engaged in for profit, the following factors are to be considered: (1) The manner in which the taxpayer carried on the activity; (2) the expertise of the taxpayer or his advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or loss with respect to the activity; (7) the amount of occasional profit, if any, which is earned; (8) the financial status of the taxpayer; and (9) whether elements of personal pleasure or recreation are involved. Sec. 1.183-2(b), Income Tax Regs. A record of losses over the years and the unlikelihood of achieving a profitable operation are important factors bearing on the taxpayer's true intention. Sec. 1.183-2(b)(6), Income Tax Regs. It is not intended, however, that only the aforesaid factors be taken into account in making the determination. Sec. 1.183-2(b), Income Tax Regs.

^{12/} See also Deegan v. Commissioner, T.C. Memo. 1985-219.

Petitioners bear the burden of proving the necessary profit objective. Rule 142(a).

Frey was WTC's general partner. He conducted the negotiations, on behalf of WTC, for the purchase of West Texas 1870. The record herein is completely lacking of any evidence as to whether Frey had any prior experience or expertise in the negotiation, purchase, and acquisition of motion pictures, yet Frey relied on Landry and Betterton's recommendation that he acquire the film for the partnership. Other than investing in a motion picture prior to 1972 -- and Landry's organizing a nonprofit company to help various civic organizations raise funds by showing films -- Landry and Betterton likewise had no experience or expertise in the movie industry.^{13/} Furthermore, both Landry and Betterton were officers of AFB at the time they recommended the purchase of the film. AFB was not a disinterested party to the transaction, and it is only reasonable to presume that Landry and Betterton had AFB's, and not WTC's interests in mind when they recommended the purchase of the film to Frey.

It is noteworthy that AFB always structured the resale of films to the investors, usually limited partnerships, in such a manner that the cash consideration received by AFB from the

^{13/} Although Axelrod had extensive experience in the film industry -- having been previously employed in managerial capacities by Warner Brothers, United Artists, Eagle Lion and Allied Artists -- AFB did not rely on his expertise in deciding which films AFB would acquire. There is similarly no evidence that Frey relied on Axelrod's expertise in purchasing the film.

investors would exceed the cash AFB paid to the producers. AFB's resale of West Texas 1870 to WTC was no exception. The motion picture purchase and sale agreement executed by AFB and Gadney on April 27, 1973, provided for a "cash" payment of \$10,000 as part of the purchase price of the film. This amount was paid as follows: (1) \$2,500 in cash; and (2) a promissory note in the principal amount of \$7,500. The agreement for the sale of the film executed on May 31, 1973, by AFB and WTC provided, inter alia, for a purchase price of \$350,000, \$25,000 of which were represented to have been paid in cash.^{14/}

Frey did not inquire about the actual production costs of the film, nor did he consult with an attorney with regard to such matters as copyrights, protection of title, or title insurance. From the onset of the "negotiations" for the purchase of the film, AFB stated that the \$350,000 purchase price and the amount of the down payment, \$25,000, were not subject to negotiation. No outside appraisal of the film was obtained prior to the purchase. The record is devoid of any evidence of Frey's inquiring about the desirability of engaging a company other than AFB to distribute the film, even though the possibility of changing the distributor after the film distribution agreement was signed was effectively curtailed by the provision contained in the said agreement -- that the investor could change the distributor only by paying the full contract amount for the film.

^{14/} See note 5, supra.

The record herein is devoid of any evidence of oral or written communications between Frey and the limited partners concerning the activities of the partnership. Nor is there evidence concerning the amount of time and effort devoted by Frey to the activity, or whether there was an expectation that the film might appreciate in value. The partnership's activity (or lack of it) resulted in claimed losses totaling \$103,834 for the years 1975 and 1976, yet there is no evidence that Frey made any efforts to improve the situation. Rather, we are satisfied that Frey delegated all control of the distribution of the film to AFB. Yet, if AFB's representations to the investors are taken as true, AFB spent less than \$13,000 between 1973 and 1977 to promote a film purportedly worth \$350,000. The film earned less than \$6,300 in gross receipts through 1977. As early as 1970, the film was reviewed by Hollywood Reporter and Variety Magazine. According to Hollywood Reporter's John Mahoney the film had "virtually no commercial interest or potential." Rick Setlowe of Variety, found that "the commercial prospects [of the film] are very limited."

There is no evidence that Frey was successful in carrying on other similar or dissimilar activities. The acquisition of West Texas 1870 was the only transaction into which WTC entered.

Alan's brief testimony at trial was limited to his assertions that: (1) He had made some high-risk investments in the past, including motion pictures; (2) he purchased an interest in WTC as an investment; and (3) he was not in the 50-percent

bracket. Petitioners' intent is, however, not determinative in ascertaining whether the activity herein was engaged in for profit. As a limited partner, petitioner had no control over the business of the partnership, did not participate in its management or conduct, and had no authority to act for or to bind the partnership. If the determination of whether the activity was engaged in for profit were made at the partner level, different results would flow to the different partners, all resulting from an act of the partnership over which the limited partners had no control. The determination is therefore made at the partnership level. See Brannen v. Commissioner, supra; Hager v. Commissioner, supra.^{15/}

We hold that petitioners have failed to carry their burden of proving the necessary profit objective. Deductions with respect to the activities herein are therefore limited as provided in sections 183(b)(1) and 183(b)(2).

We now turn to section 183(b)(1) to determine the amount, if any, of the deductions which are allowable. This determination is also made at the partnership level.

Section 163(a) allows a deduction for "all interest paid or accrued within the taxable year on indebtedness."

^{15/} See also Estate of Freeland v. Commissioner, 393 F.2d 573 (9th Cir. 1968), affg. a Memorandum Opinion of this Court, where the taxpayer argued that as a limited partner, the intent of the operating partners in the partnership should not be attributed to her. In rejecting this contention, the Second Circuit stated that while the limited partnership may have been an investment to her, the intent of the partnership controlled in determining whether the land owned by the partnership was property described in sec. 1221(1).

Respondent disallowed the portion of petitioners' claimed loss attributable to purported interest paid by WTC to AFB with respect to the nonnegotiable promissory note on the grounds that petitioners had failed to prove that the amount was paid or accrued by WTC in 1976; or that the said amount, if paid, represented interest on valid indebtedness.

WTC used the cash receipts and disbursements method of accounting. Under this method, amounts representing allowable deductions, with exceptions not pertinent herein, are taken into account for the taxable year in which paid. Sec. 1.461-1(a)(1), Income Tax Regs.

In Hager v. Commissioner, 76 T.C. at 773-774, we stated:

It is settled that amounts paid as interest must be paid on genuine indebtedness to be deductible under section 163(a) (Knestch v. United States, 364 U.S. 361 (1960); Narver v. Commissioner, 75 T.C. 53, 98 (1980), on appeal (9th Cir., Jan. 15, 1981); Golsen v. Commissioner, 54 T.C. 742, 754 (1970), affd. 445 F.2d 985 (10th Cir. 1971)) * * *. In the usual sale of property, if part or all of the purchase price is deferred, the obligation to pay the deferred amount represents genuine indebtedness and an investment in property. Mayerson v. Commissioner, at 351-352 * * *

Such conclusion does not follow, however, where the principal amount of the indebtedness or the purchase price unreasonably exceeds the value of the purchased property because the purchaser has no incentive to pay off the obligation.^{16/} If the purchase

^{16/} In Brannen v. Commissioner, 78 T.C. 471 (1982), affd. 722 F.2d 695 (11th Cir. 1984), this Court stated that the test was whether the stated purchase price unreasonably exceeded the value (footnote continued)

price and the principal amount of the note unreasonably exceed the value of the property to be purchased, then no genuine indebtedness exists. Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976), affg. 64 T.C. 752 (1975); Odend'hal v. Commissioner, 80 T.C. 588, affd. on this issue 748 F.2d 908 (4th Cir. 1984); Brannen v. Commissioner, supra; Hager v. Commissioner, supra.

The burden of proving that amounts were paid, which amounts represented interest paid on a valid indebtedness, is on petitioners. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a).

Other than WTC's partnership return for its taxable year 1976, claiming a deduction in the amount of \$15,670 allegedly paid as interest, the record is devoid of any evidence that the said amount was actually paid. Tax returns are not self-proving. Halle v. Commissioner, 7 T.C. 245 (1946), affd. 175 F.2d 500 (2d Cir. 1949), cert. denied 338 U.S. 949 (1950).

Even assuming, arguendo, that the claimed amount was actually paid by WTC as interest, it must have also been paid on a valid indebtedness. West Texas 1870 was acquired by AFB upon payment of \$2,500 in cash, delivery of a nonnegotiable promissory note in the principal amount of \$7,500, and signature of an

(footnote continued from previous page)
of the property, whereas in Hager v. Commissioner, 76 T.C. 759 (1981), this Court stated that the test was whether the principal amount of the nonrecourse indebtedness unreasonably exceeded the value of the property. On the basis of resolution herein, we need not decide this issue.

agreement providing for a percentage of net proceeds, if any, on April 27, 1973 (see our findings of fact, supra). On May 31, 1973, WTC purchased the film from AFB for a stated price of \$350,000, plus a percentage of the net profits, if any. There is no evidence of this record regarding the value of the film as of May 31, 1973, which would justify such a price.

Petitioners have failed to show error in the notice of deficiency. The portion of the loss attributable to alleged interest payments on the nonnegotiable note is accordingly disallowed.

With respect to amounts allowable under section 183(b)(2), petitioners have failed to prove that they are entitled to any amounts in excess of those allowed by respondent.^{17/} In this respect, petitioners' failure to prove that the nonnegotiable promissory note constitutes a valid indebtedness, viz, that the purchase price or the principal amount of the note did not unreasonably exceed the fair market value of the film, precludes the inclusion of the principal amount of the note in basis for purposes of computing allowable depreciation of the film. See Estate of Franklin v. Commissioner, supra.

^{17/} In calculating the amount of the deficiency herein, respondent disallowed only petitioners' distributive share of the net loss of the partnership, i.e., respondent disallowed only the distributive share of the loss that was in excess of WTC's gross receipts from the activity. Because of our determination that petitioners failed to prove that the activity was engaged in for profit, petitioners derive no further benefits from the provisions of sec. 183 (b)(2).

Issue 2. Deduction for Out-of-Pocket Expenses

Petitioners claim entitlement to a deduction in the amount of \$1,867 allegedly paid to WTC during 1976.

In order for an interest deduction to be allowable under section 163(a), cash basis taxpayers like petitioners must prove that: (1) Payment was made within the taxable year; and (2) the indebtedness is genuine. Hager v. Commissioner, supra; Rule 142(a).

As we have found, Alan paid a total of \$1,400.25 to WTC in 1976. Thus, petitioners' deduction, if otherwise allowable, is limited to \$1,400.25, representing the total amount of payments made to WTC in 1976.

Where periodic payments consisting of both principal and interest elements are received, the general rule, known as the "United States Rule," is that such periodic payments are applied first to interest, with any remaining amount being applied to principal, absent any agreement of the parties to the contrary. Story v. Livingston, 38 U.S. (13 Pet.) 359 (1839); Estate of O'Leary v. Commissioner, T.C. Memo. 1986-212. The nonnegotiable promissory note in the principal amount of \$35,000, dated April 6, 1973, that was signed by Alan provided that in 1976 payment for principal was due on June 30, 1976 and interest was due on December 15, 1976 in the respective amounts of \$300 and \$1,567. The note also provided that all payments on the note were to be credited first to interest "then due" and the remainder to principal.

Petitioners do not argue -- and the record does not show -- that there was any interest due on the note as of March 1, 1976, when the first check in the amount of \$466.75 was delivered to WTC by Alan. In accordance with the provisions of the nonnegotiable promissory note, \$300 of the said \$466.75 are therefore allocable to principal, which was due on June 30, 1976. The remaining \$166.75 of the \$466.75, together with the \$933.50 in payments made on May 29, 1976, and September 1, 1976, totaling \$1,100.25, constitute interest which was not due until December 15, 1976.

Although respondent's statutory notice, quoted in relevant part in our findings, was broad enough to encompass the determinations that (a) the entire WTC partnership was a sham and (b) that the West Texas 1870 film venture was not entered into by WTC for profit, the entire thrust of respondent's case, both at trial and on brief, was limited to point (b). Respondent did not request any finding that the entire WTC partnership was a sham or was otherwise not to be recognized for tax purposes, and we have made no such finding. While we have upheld respondent's determination regarding the West Texas 1870 venture, it does not automatically follow that WTC was otherwise an invalid or sham organization. As our findings show, WTC was empowered by its articles to enter into other ventures. The fact that no other such ventures were undertaken through 1976 does not preordain

that they would have been disregarded for tax purposes if they had been undertaken, using any available capital, including Alan's contribution.

Petitioners have established that: (1) Alan became a limited partner of WTC in 1973, under an apparently valid and binding agreement of limited partnership executed on May 31, 1973; (2) in accordance with the provisions of the agreement, Alan executed a bona fide promissory note -- which was unconditional and with full recourse -- in the principal amount of \$35,000, providing for principal and interest payments as stated in our findings of fact, supra; and (3) Alan made payments totaling \$1,400.25 in 1976, of which payments \$300 and \$1,100.25 are allocable to principal and interest, respectively.

Petitioners thus made out a prima facie case for deductibility of the interest portion, and the burden of going forward with the evidence then shifted to respondent to prove that petitioners were not entitled to deduct \$1,100.25 as interest. Respondent has not presented any such evidence. We are satisfied, and so hold, that petitioners are entitled to deduct \$1,100.25 paid as interest on the nonnegotiable promissory note to WTC in 1976, under section 163(a).

To reflect the foregoing,

Decision will be entered
under Rule 155.

Jul 11.7/2: 1986-242

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T. C. Memo. 1986-242

UNITED STATES TAX COURT

IVAN K. LANDRETH and LUCILLE LANDRETH, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 4432-83.

Filed June 16, 1986.

Robert J. Shaw and Eve M. Fitzsimmons, for the
petitioners.

Theodore J. Kletnick, for the respondent.

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SUPPLEMENTAL MEMORANDUM OPINION

SCOTT, Judge: On August 12, 1985, this Court filed its Memorandum Findings of Fact and Opinion in the above-entitled case, Landreth v. Commissioner, T.C. Memo. 1985-413, in which it was stated that decision would be entered under Rule 155. On April 22, 1986, respondent filed his computation for entry of decision under Rule 155, and on April 23, 1986, petitioners filed their computation for entry of decision under Rule 155. Each party filed a memorandum in support of his computation and each party filed a reply to the memorandum of the other party. The differences in the computations result from the method by which the amount of capital gain for the year 1978 from an installment sale is computed. In petitioners' computation, the capital gain is computed by use of a gross profit percentage of 77.20 percent, based on petitioners' statement that this amount was shown on their amended 1977 return. In respondent's computation, the gross profit percentage is 93.29 percent, based on the computation used in petitioners' original income tax returns for the calendar years 1977 and 1978.

Initially, it appears to the Court that the claim by petitioners that a gross profit percentage less than that used in the original return filed by petitioners for the years 1977 and 1978 should be used is an attempt by petitioners to raise a new issue in a proceeding under Rule

155. It is well settled that a new issue may not be raised in a Rule 155 proceeding. Bankers' Pocahontas Coal Co. v. Burnet, 287 U.S. 308 (1932); Cloes v. Commissioner, 79 T.C. 933 (1982); Estate of Papson v. Commissioner, 74 T.C. 1338, 1340 (1980).

All facts necessary to determine the issue which petitioners raise in the Rule 155 computation were not contained in the record made at the trial of this case, and effectively it requires a reopening of the record to decide the issue raised by petitioners. However, on April 22, 1986, the parties filed with the Court a Stipulation of Facts which incorporated those facts necessary to decide the issue raised in the Rule 155 computation which were not in evidence in this case prior to the filing of the memorandum opinion on August 12, 1985. Respondent submitted this Stipulation of Facts for filing along with his computation under Rule 155 and at no point raised any objection to petitioners' raising a new issue under Rule 155. In view of the fact that effectively both parties have asked that we reopen the record to accept the additional evidence contained in the Stipulation of Facts filed by the parties on April 22, 1986, and decide the issue raised by petitioners, we will grant what in our view amounts to a joint motion to reopen the record to receive the Stipulation of Facts and decide the new issue raised by the parties.

The facts as stipulated show that in 1977 petitioners sold their stock in Landreth Timber Co. and elected on their 1977 joint Federal income tax return to report their gain of \$1,914,292 on the installment method. The contract price for the stock was \$2,052,000 and the cost basis of the stock to petitioners was \$137,708. On their 1977 joint Federal income tax return, petitioners reported \$496,303 in installment sale gain based on the receipt by petitioners of a \$532,000 installment payment in 1977 to which a profit percentage of 93.29 percent was applied. This profit percentage was arrived at by dividing the \$1,914,292 gain on the sale of the timber company stock by the \$2,052,000 contract price of the stock. On their 1978 joint Federal income tax return, petitioners reported \$1,418,008 in installment sale capital gain based on the receipt by petitioners of a \$1,520,000 payment to which the profit percentage of 93.29 percent was applied.

As is shown in the memorandum opinion filed in this case (T.C. Memo. 1985-413), in 1978 litigation concerning the stock sale arose and petitioners began to incur legal fees and related expenses in connection with this litigation. During the years 1978 through 1982, petitioners incurred the following legal and related expenses:

1978	\$ 1,379	
1979	164,716	(including a commission of \$22,000)
1980	165,332	
1981	134,850	
1982	85,025	
Total	\$551,302	

On April 15, 1981, petitioners filed an amended return for the taxable year 1977 in which they claimed that the legal fees and the \$22,000 commission totaling \$330,048 incurred in 1979 and 1980 should be added to the cost of the sale of the timber stock and thereby reduce the gross profit ratio to determine gain on the sale for 1977 to 77.20 percent.¹ Petitioners applied the 77.20 percent to the \$532,000 amount received in 1977, thereby arriving at an installment sale capital gain of \$410,704 in 1977. This recomputation resulted in petitioners claiming a refund of 1977 taxes in the amount of \$32,547. On April 15, 1981, petitioners also filed an amended return for the taxable year 1978 in which they claimed a refund for that year based on using a profit percentage to be applied to the \$1,520,000 received in that year of 77.20 percent. On December 7, 1981, respondent accepted petitioners' claim for refund for the year 1977 after an audit of that year by one of respondent's agents. On February 8, 1982, petitioners' claimed

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This amount was arrived at by subtracting from \$1,914,291 the amount of \$330,048, resulting in \$1,584,244 of gain on the sale, which was divided by the \$2,052,000 contract price to arrive at the 77.20 percent.

overpayment for the year 1977 in the amount of \$32,547 plus interest was applied against petitioners' 1979 tax liability. Respondent has never issued, nor have petitioners received, a statutory notice of deficiency or a deficiency assessment for their taxable year 1977. Any assessment of a deficiency for the year 1977 is barred by the statute of limitations.

On April 2, 1982, petitioners filed a second amended return for the taxable year 1978 claiming a capital loss of \$142,903 representing legal fees incurred during 1981, which loss they claimed on this return should be applied against the capital gain in 1978, but on the second amended return this amount was not used to further reduce the gross profit percentage of 77.20 percent which petitioners had computed in 1977 and claimed on their first amended return for 1978.

On December 29, 1982, petitioners filed a third amended return for the taxable year 1978 claiming a capital loss of \$79,322 representing legal fees incurred by petitioners in 1982. That loss was likewise applied against the capital gain petitioners had reported in 1978, but was not used to further reduce the gross profit percentage of 77.20 percent used in their amended 1977 return and their first amended 1978 return. The claims for refund reflected by petitioners' amended return for 1978, second amended return for 1978, and third amended return for 1978 have not been allowed or disallowed by respondent.

On December 5, 1982, respondent issued a notice of deficiency to petitioners for the taxable year 1978, and petitioners in their petition filed with the Court on February 25, 1983, from the December 5, 1982, notice of deficiency claimed that they should be allowed to deduct as capital losses the legal fees in the amounts of \$142,903 and \$79,322 incurred during the years 1981 and 1982. The Court, in Landreth v. Commissioner, T.C. Memo. 1985-413, decided this issue against petitioners and held that the legal fees incurred in 1981 and 1982 by petitioners were not deductible in 1978 but were proper deductions in the years incurred. The year 1977 was not and is not before the Court in this case.

In our view, our holding with respect to the claimed deduction of legal fees incurred in 1981 and 1982 in effect disposes of the merits of petitioners' claim in this proceeding under Rule 155 that the legal fees incurred in 1979 and 1980 should be used to reduce the installment sale capital gain reported in 1978. Although not precisely so stated, petitioners apparently recognize this because their argument is directed primarily to their contention that since respondent accepted their amended return for 1977, thereby permitting a gross profit percentage of 77.20 percent to be used in that year to determine the amount of installment sale capital gain for the year 1977, he should be required to

permit them to use this same gross profit percentages for the calendar year 1978.

Although not cast in the terms of estoppel, petitioners are effectively so arguing by contending that by accepting the 1977 amended return respondent is required to accept the same profit percentage in 1978. Estoppel does not bar the correction of a legal error. Automobile Club of Michigan v. Commissioner, 353 U.S. 180, 184 (1957), and it may be for this reason that petitioners do not argue their point in the terms of estoppel. In view of our holding with respect to the 1981 and 1982 legal fees, it is clear that respondent's allowance of the use of the lower profit percentage, and therefore his allowance of petitioners' 1977 refund claim, was an error of law. Petitioners in effect recognize this, since they cite in their memorandum and rely primarily on cases holding that respondent cannot recoup in an open year an amount erroneously allowed in a prior year. No point would be served by a discussion in detail of the cases cited by petitioners, since it is clear to us under the facts here stipulated that respondent is not attempting in 1978 to recoup an erroneous allowance of an overpayment in 1977 but rather is merely contending that no further erroneous overpayment should be made in 1978.²

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Petitioners on their original 1979 return deducted as a capital loss the attorney's fees and commission incurred in
(footnote continued)

Respondent cites a number of cases dealing with a change in the sales price of property the gain from the sale of which had been reported under the installment sales method in a year subsequent to the year of sale. These cases hold that the price is adjusted only in the year the change occurs and subsequent years and that no retroactive adjustment is made. We need not discuss these cases since in our view they also are not pertinent to the issue here presented.

Petitioners in this case are merely contending that respondent should be bound by a mistake of law made in a prior year. The cases are uniform that in a subsequent year respondent is not bound by a mistake of law made in a prior year. Automobile Club of Michigan v. Commissioner, *supra*; Burlington Northern Railroad Co. v. Commissioner, 82 T.C. 143, 146 (1984); Electric & Neon, Inc. v. Commissioner, 56 T.C. 1324, 1333 (1971), *affd.* without published opinion 496 F.2d 876 (5th Cir. 1974).

The only further argument that petitioners make is that respondent should be bound by the doctrine of consistency to allow the use of the profit percentage in 1978 which was

(footnote continued from previous page)
that year. Although the record is not clear, they apparently filed an amended 1979 return reversing this action and did not claim as a capital loss the attorney's fees incurred in 1980. The record does not show whether the statute of limitations has expired as to petitioners' 1979 and 1980 taxable years. In any event, any errors in petitioners' returns for 1979 and 1980 do not justify allowing an erroneous adjustment in 1978 to permit a possible recoupment for errors made in petitioners' 1979 and 1980 returns.

allowed in 1977. The cases petitioners cite in support of this argument are so factually different from the situation here that any detailed discussion of those cases is unwarranted. Those cases involve situations in which the taxpayers have kept records or reported an item in a certain manner over an extended period of years with respondent's approval, and respondent proposes to retroactively change the prior approved method. For further discussion of this point, see Electric & Neon, Inc. v. Commissioner, supra at 1333.

After consideration of all the arguments advanced by the parties, we conclude that respondent's computation for entry of decision under Rule 155 is the correct computation, and our decision will be entered in accordance with that computation.

An appropriate decision
will be entered.

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T. C. Memo. 1986-243

UNITED STATES TAX COURT

DEWEY D. HALLIGAN and DORIS A. HALLIGAN, ET AL.,¹ Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 7418-83,
7419-83,
7420-83,
7421-83.

Filed June 17, 1986.

Dean R. Westly, for the petitioners.

David L. Lau, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

JACOBS, Judge: Respondent determined the following
deficiencies in petitioners' Federal income taxes:

¹ Cases of the following petitioners are consolidated
herewith: Hepco, Inc., docket No. 7419-83; Hepco, Inc. Profit
Sharing Plan and Trust, docket No. 7420-83; and Clarence Nelson,
docket No. 7421-83.

<u>Docket No.</u>	<u>Petitioners</u>	<u>Taxable Year</u>	<u>Deficiency</u>
7418-83	Dewey D. Halligan and Doris A. Halligan	1977 1978 1979	\$ 5,185 15,586 45,537
7419-83	Hepco, Incorporated	1978 1979	49,955 107,494
7420-83	Hepco, Inc. Profit Sharing Plan and Trust	1978 1979	116 771
7421-83	Clarence Nelson	1978 1979	170 592

The issues for decision are:

(1) Whether the amounts of compensation paid to Dewey and Doris Halligan by Hepco, Inc. during 1978 and 1979 were reasonable, and

(2) Whether the trust forming a part of the Hepco, Inc. Profit Sharing Plan and Trust was a qualified trust under section 401(a)², and thus was tax exempt under section 501(a), for its plan years ended March 31, 1978 and 1979.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and the exhibits attached thereto are incorporated herein by this reference.

Dewey and Doris Halligan, husband and wife, resided in San Jose, California at the time they filed their petition.

² All section references are to the Internal Revenue Code of 1954, as amended and in effect during the taxable years in issue.

Hepco, Inc. is a California corporation which was organized in May, 1974. All the stock of Hepco, Inc. is owned by Dewey and Doris Halligan. At all relevant times, the corporation's principal place of business was in Sunnyvale, California.

Hepco, Inc. adopted the Hepco, Inc. Profit Sharing Plan (the Plan) and Trust (the Trust) on March 27, 1975. Dewey and Doris Halligan were the Trustees of the Trust; the Trust's fiscal year end was March 31. The Plan's principal office at all relevant times was in Sunnyvale, California.

Clarence Nelson (Nelson) was an employee of Hepco, Inc. during 1978 and 1979. Nelson resided in Sunnyvale, California at the time he filed his petition.

In 1969, while working for Memorex Corporation, Dewey conceived and developed a machine which would trim and form the wire leads for various electronic components used in the assembly of printed circuit boards. After receiving a letter from Memorex which permitted Dewey to exploit his invention, Dewey applied for, and obtained in 1971, a patent on this machine.

In 1972, Dewey started his own business in his garage, constructing machinery for use in the manufacture of printed circuit boards. He named the business Hepco, an acronym for Halligan Engineering Products Company.

In 1972, Dewey obtained a patent on an automatic transistor lead forming and cutting machine; and in 1974, he obtained a patent on a dual in-line pack lead forming and cutting machine.

By 1973, Hepco had generated enough profits to enable the business to move from the Halligans' garage. In 1974, Dewey transferred all the assets³ of his sole proprietorship to Hepco, Inc. (hereinafter referred to as Hepco) in exchange for all 4,334 shares of its outstanding capital stock and Hepco's promissory note in the amount of \$50,000.⁴ Dewey was the president, treasurer, and chairman of the board of directors of Hepco. Doris was Hepco's vice-president, secretary, and a member of its board of directors.

1. Reasonable Compensation

Dewey performed the executive duties of Hepco. He marketed Hepco's machines, attended trade shows, managed its production, custom designed machines to fit the needs of Hepco's customers, and handled post-sale adjustments to the machines and customer

³ The assets transferred were:

	<u>Stated Value</u>
Cash	\$ 5,000.00
Accounts receivable	13,015.65
Inventories (at cost)	17,089.97
Depreciable assets (at net book value)	1,333.00
Automobile (cost minus depreciation)	4,988.00
Patents	50,920.00
Goodwill	1,000.00
	<u>\$93,346.62</u>

⁴ The note bore interest at the rate of 10 percent per annum and was payable in monthly installments over a five-year period.

complaints. His corporate duties occupied almost all of his time; he worked evenings and weekends. He had no hobbies, belonged to no social clubs and rarely took vacations.

Doris was Hepco's bookkeeper. Her duties included posting and collecting the corporation's accounts receivable, paying its bills, reconciling bank statements, and preparing the corporation's payroll. She assisted Dewey in preparing for trade shows (but did not attend them) and formulated advertisements for Hepco's machines. Because Doris had to care for her 12 year old daughter, she performed most of her corporate duties at home. Hepco engaged the services of an accounting firm which established an accounting system for Hepco, reviewed its books, and prepared its tax returns.

During the first few years of Hepco's existence, Dewey and Doris were its only employees. Thereafter, the business grew and others were hired. As the business grew, so did Dewey's and Doris' salaries. Dewey and Doris received bonuses near the end of Hepco's fiscal year (March 31st). Prior to May 31, 1978, no formula was used for determining the amount of bonus paid. After May 31, 1978, a formula was established to determine Dewey's bonus, but not that of any other employee of Hepco. Dewey's bonus was set at 25 percent of Hepco's net profits.

The following is a summary of Hepco's gross receipts, taxable income, and retained earnings for the fiscal years ended March 31, 1975 through and including March 31, 1979:

<u>Fiscal Year Ended March 31</u>	<u>Gross Receipts</u>	<u>Taxable Income</u>	<u>Retained Earnings</u>
1975	\$ 142,878	\$ 19,943	\$ 19,943
1976	142,779	19,543	35,188
1977	393,563	105,402	136,565
1978	763,633	212,848	313,340
1979	1,005,246	258,117	417,182

Since its inception, Hepco has declared but one dividend, which was on May 31, 1978 in the amount of \$1 per share. The total dividend payment was thus \$4,334.

The following summarizes the amounts of base salaries and bonuses paid to Dewey and Doris during the fiscal years ended March 31, 1975 through and including March 31, 1979:

<u>Fiscal Year Ended March 31</u>	<u>Dewey</u>			<u>Doris</u>		
	<u>Base Salary</u>	<u>Bonus</u>	<u>Total</u>	<u>Base Salary</u>	<u>Bonus</u>	<u>Total</u>
1975	\$ 30,000	\$ 10,000	\$ 40,000	\$10,000	\$ 2,000	\$12,000
1976	25,557	-	25,557	15,000	-	15,000
1977	32,550	17,450	50,000	11,250	8,750	20,000
1978	60,000	75,000	135,000	20,000	15,000	35,000
1979	130,000	112,002	242,002	30,000	20,000	50,000

Other employees of Hepco received relatively little or no bonuses for fiscal years 1978 and 1979⁵. Hepco provided its

⁵ The amount of bonuses paid to all employees (including Dewey and Doris) for fiscal years 1978 and 1979 was \$96,000 and
(footnote continued)

employees with health and life insurance.⁶ It also had a profit sharing plan for its salaried employees.

During fiscal years 1978 and 1979, Hepco made the following contributions to its profit sharing plan on behalf of Dewey and Doris:

<u>Plan Year Ended March 31</u>	<u>Dewey</u>	<u>Doris</u>
1978	\$20,250	\$5,250
1979	36,303	7,500

Respondent determined that the compensation paid by Hepco to Dewey and Doris (including contributions to the Plan) during fiscal years ended March 31, 1978 and 1979 exceeded that which would constitute "a reasonable allowance for salaries and compensation for personal services rendered" within the meaning of section 162(a)(1). The following shows respondent's determination with respect to the reasonable compensation issue:

(footnote continued from previous page)
\$145,102, respectively. Thus, for fiscal years 1978 and 1979, Dewey and Doris together received 94 percent and 91 percent, respectively, of the amount of all bonuses paid.

⁶ Dewey, as president of the corporation, could authorize the corporation to pay for reasonable medical and dental expenses not covered by the corporate health plan on a discretionary basis.

	<u>1978</u>		<u>1979</u>	
	<u>Dewey</u>	<u>Doris</u>	<u>Dewey</u>	<u>Doris</u>
Compensation Paid (Salary and Bonus)	\$135,000	\$35,000	\$242,002	\$50,000
Contribution to Profit Sharing Plan	<u>20,250</u>	<u>5,250</u>	<u>36,303</u>	<u>7,500</u>
	\$155,250	\$40,250	\$278,305	\$57,500
Amount Deemed Reasonable	96,199	14,735	117,858	15,178
Amount Disallowed	<u>59,051</u>	<u>25,515</u>	<u>160,447</u>	<u>42,322</u>

2. Tax Status of Plan

By letter dated April 14, 1975, respondent determined that the Trust qualified under section 401(a) and was tax-exempt under section 501(a). The determination letter contained a caveat that it would not be effective for plan years beginning after September 2, 1974.⁷ Thus, the letter covered only the plan year which ended March 31, 1975. The Plan provided that Hepco could make contributions of up to 15 percent of an employee's salary and bonus. The Plan covered only salaried employees. The following shows those persons who were employed by Hepco on March 31, 1978 and 1979, the amounts of salary and bonus paid to each, and whether the employee was a participant in, or excluded from, the Plan:

⁷ On September 2, 1974, the Employee Retirement Income Security Act (ERISA) was enacted, Pub.L. 93-406, 88 Stat. 829.

1978

<u>Employees at Fiscal Year End</u>	<u>Salary & Bonus for Year (Annualized)</u>	
	<u>Participant</u>	<u>Excluded</u>
Halligan, Dewey	\$135,000.00	
Halligan, Doris	35,000.00	
Marithew, A.		\$20,286.00
Nelson, C.	17,900.00	
Eck, K.	13,300.00	
Fenton, M.		11,720.00
Gary, R.		9,960.00
Gribble, K.		9,760.00

1979

<u>Employees at Fiscal Year End</u>	<u>Salary & Bonus for Year (Annualized)</u>	
	<u>Participant</u>	<u>Excluded</u>
Halligan, Dewey	\$242,002.00	
Halligan, Doris	50,000.00	
Nelson, C.	20,000.00	
Fenton, M.		\$15,000.00
Gray, R.		14,480.00
Gribble, K.		12,400.00
Apodaca, R.		11,880.00

Gauthier, D.

6,860.00

For fiscal years 1976 through 1979, Hepco contributed the following amounts to the Plan on behalf of its employees:

<u>Employee</u>	<u>Employer Contribution</u>			
	<u>1976</u>	<u>1977</u>	<u>1978</u>	<u>1979</u>
Halligan, Dewey	\$3,837	\$7,500	\$20,250	\$36,303
Halligan, Doris	2,250	3,000	5,250	7,500
Nelson, C.	-	630	2,685	3,143
Eck, K.	-	-	2,054	N/A
Labutski	-	2,174	-	-

Full vesting in the Plan occurred when the participant's employment with Hepco terminated by retirement, by death or by reason of total disability. In the event the participant's employment terminated for any other reason, his vested interest depended on the number of years of service he had accrued at the time of termination. The Plan contained the following vesting schedule:

<u>Years of Service</u>	<u>Percentage Vested</u>
1	5
2	10
3	15
4	20
5	25
6	30
7	35
8	40
9	50
10	100

Respondent claims that in fiscal years 1978 and 1979, the Trust did not qualify for tax exemption under section 501(a) because the Plan failed to satisfy the qualification requirements of sections 401(a)(7), 401(a)(12), 401(a)(14), and 401(a)(16). Even if the Plan qualified in form, claims respondent, it did not qualify in operation because it discriminated in favor of employees who were officers, shareholders or highly compensated. According to respondent, disqualification of the Trust mandates inclusion of Hepco's contributions to the Plan in the incomes of Dewey, Doris, and Nelson.

Dewey and Doris Halligan assert that they were unaware that the Trust did not satisfy all requirements for qualification. They maintain that the Plan and Trust were operated and administered in good faith and were in substantial compliance with the law. The Halligans contend that once they were informed that the Plan did not comply with all the technical statutory requirements for qualification, they and Hepco were willing to take all necessary actions and make all changes necessary to bring the Plan into compliance with the statutory requirements.

Petitioners further claim that the Plan is not discriminatory in operation because it covers a fair cross-section of Hepco's employees. Alternatively, petitioners argue, even if the Trust is not qualified, Hepco is entitled to deduct its contributions to the Trust to the extent such contributions are included in the income of the Plan participants.

OPINION

Issue 1. Reasonable Compensation

Section 162(a)(1) allows as a deduction all "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including * * * a reasonable allowance for salaries or other compensation for personal services actually rendered."⁸

The reasonableness of the amount of compensation paid for services depends upon the facts and circumstances of the particular case. Amounts which are designated as salary payments to shareholder-employees of a closely-held corporation may, in fact, be distributions of profits (which are not deductible by the corporation). Thus, because employees who are controlling shareholders of closely-held corporations set their own compensation, the reasonableness of the amount of such compensation necessitates our close scrutiny in order to determine if the payment is what it purports to be or is in

⁸ Section 1348 limits the maximum rate on personal service taxable income to 50 percent; this 50 percent maximum tax rate applies to compensation income, not to dividend income.

reality a distribution of corporate profits. Trinity Quarries, Inc. v. United States, 679 F.2d 205 (11th Cir. 1982); Levenson & Klein, Inc. v. Commissioner, 67 T.C. 694, 711 (1977).

Factors considered in determining the amount of compensation that is reasonable include:

- (1) the employee's role in the company;
- (2) the size and complexity of the company's business;
- (3) a comparison of the employee's salary with the salaries paid by similar companies for similar services;
- (4) a comparison of the employee's salary with the gross income and net income of the company;
- (5) the salary policy of the company for all its employees;
- (6) a comparison of the amount of salaries paid to the amount of distributions to stockholders; and
- (7) whether an inactive, independent investor would be willing to compensate employees like Dewey and Doris at the salary levels Dewey and Doris received.

No one single factor is dispositive; all factors must be considered. Mayson Mfg. Co. v. Commissioner, 178 F.2d 115 (6th Cir. 1949), revg. a Memorandum Opinion of this Court; Elliotts, Inc. v. Commissioner, 716 F.2d 1241 (9th Cir. 1983), revg. and remanding a Memorandum Opinion of this Court.

After a careful review of the entire record, and after considering all of the factors set forth above, we believe that the amounts of Dewey's and Doris' compensation payable in the

form of salaries and bonuses which were reasonable for Hepco's fiscal years ended March 31, 1978 and 1979 (excluding contributions made to the Plan) would have been as follows⁹:

	<u>Fiscal Year Ended March 31, 1978</u>	<u>Fiscal Year Ended March 31, 1979</u>
Dewey	\$100,000	\$150,000
Doris	20,000	25,000

We recognize that Dewey was primarily responsible for Hepco's success, yet we also must keep in mind that Hepco was not only a relatively small corporation during 1978 and 1979 but that Hepco was a manufacturing company, not a personal service company. We also recognize that it is not unusual to pay year-end bonuses based on the success of the business; however, we note that the amount of the bonuses paid to Dewey and Doris were relatively high and that little, if any, bonuses were paid to nonstockholder-employees. In our opinion, a company similar to Hepco in size and complexity would pay a salary and bonus to a person performing services similar to those performed by Dewey for Hepco not exceeding \$100,000 for 1978 and \$150,000 for 1979. Insofar as Doris is concerned, we believe that such a company

⁹ As discussed infra, a percentage of the contributions to the Plan are also includible in income. The total reasonable compensation paid by Hepco to Dewey and Doris includes the amounts set out above plus amounts included in income under section 83.

would pay a salary and bonus to a person performing services similar to those performed by her not exceeding \$20,000 for 1978 and \$25,000 for 1979.

The dollar amount of increase in salary and bonus from 1977 to 1978 and from 1978 to 1979 for both Dewey and Doris are highly disproportionate to the amount of increases paid to the other employees of Hepco. In our opinion, had Dewey and Doris not been the sole shareholders of Hepco, they would not have received such large salaries and bonuses nor would they have received such large increases from year to year.

We have considered the testimony of petitioners' expert witness and find it unpersuasive. Respondent presented no expert testimony and offered no explanation as to how he arrived at the amounts of compensation he deemed to be reasonable. Thus, to a large extent, we were given little useful guidance.

As to the amounts which we have determined to be paid to the Halligans in excess of reasonable compensation, Hepco is not entitled to a deduction. The burden of proof remained with petitioners to show that respondent erred when it determined that such amounts were taxable as dividends. Nor-Cal Adjustors v. Commissioner, 503 F.2d 359 (9th Cir. 1974), affg. a Memorandum Opinion of this Court. Section 1.162-7(b), Income Tax Regs., provides that where unreasonable salaries are paid to shareholders and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it "would seem likely" that the excessive payments are

a distribution of earnings. Here, the only recipients of unreasonably high compensation were Hepco's shareholders and officers. Hepco paid no dividends in 1978, and paid only an insubstantial amount in 1979. Accordingly, we hold that respondent correctly characterized the excessive payments to the Halligans as dividends which are not subject to the 50 percent maximum tax rate provided for in section 1348.

Issue 2. Tax Status of Plan

Section 404(a)(3) allows a deduction, subject to limitations, for employer contributions to a tax-exempt profit-sharing trust. A profit-sharing trust is exempt from taxation under section 501(a) if the plan of which it is a part meets all the qualification requirements set forth in section 401(a). Section 401(a) sets forth twenty-one qualification requirements. These requirements fall into two categories-- requirements as to form and requirements as to operation of the plan. There is no dispute that the Plan did not satisfy all the form requirements. However, Petitioners argue that the Trust should be treated as a qualified trust because:

(1) the Plan was submitted to the Internal Revenue Service for determination and qualification and a favorable determination letter was received.

(2) the Plan was operated and administered in good faith.

(3) the Plan was in substantial compliance with the law and any technical defects were correctable pursuant to the provisions of the ERISA Non-Compliance Enforcement Program (ENCEP).¹⁰

(4) Dewey, on behalf of Hepco and the Plan, offered to do whatever was necessary to bring the Plan into compliance once he became aware that the Plan was defective in form.¹¹

While we are sympathetic to petitioners' plight, we agree with respondent that the Trust is not a qualified tax-exempt profit sharing trust. Respondent's determination letter explicitly provided that qualification would not be effective for plan years beginning after September 2, 1974. We accept petitioners' assertion that at all times they acted in good faith. This Court has held, however, that the good faith intentions of petitioners do not satisfy the statutory requirements of sections 401, et seq. Gillis v. Commissioner, 63 T.C. 11, 17 (1974). We have in the past rejected taxpayers'

¹⁰ In response to petitioners' request for relief under ENCEP, respondent argues:

(1) ENCEP, as extended, expired on December 31, 1983; thus, it is not now available to petitioners, and

(2) ENCEP is a discretionary function of the Secretary of the Treasury.

We agree with respondent.

¹¹ Respondent contends, and petitioners concede, that Hepco made contributions to the Plan in excess of the limitation imposed by section 415. Petitioners argue, however, that the error was inadvertent and is correctable.

argument that we should balance the minimal harm caused by a defective plan provision never brought into operation against the harm to plan participants if the plan is not qualified. Tionesta Sand & Gravel, Inc. v. Commissioner, 73 T.C. 758 (1980), affd. in an unpublished opinion 642 F.2d 444 (3rd Cir. 1981). Where a trust fails to specifically comply with the literal requirements of section 401, and such compliance cannot be inferred from a reading of the plan as a whole, we have declined to find that the trust nevertheless qualified under section 401. Bolinger v. Commissioner, 77 T.C. 1353 (1981).

Even if we excused compliance with the form requirements of section 401, we agree with respondent that the Plan is discriminatory in operation.

Section 401(a)(3) provides that a trust, in order to constitute a qualified trust, must satisfy the participation standards of section 410. Section 410(b)(1) provides that a trust is not qualified under section 401(a) unless it benefits a specific percentage of employees,¹² or the classification of employees under the plan is found by the Secretary not to be discriminatory in favor of employees who are officers, shareholders or highly compensated (hereinafter referred to as prohibited group employees).¹³ Petitioners do not contend that they satisfy the percentage requirements set forth in section

¹² Section 410(b)(1)(A).

¹³ Section 410(b)(1)(B).

410(b)(1)(A). Rather, petitioners contend that they have met the "fair cross section" test set forth in Revenue Ruling 83-58, 1983-1 C.B. 95, and that the Trust was therefore qualified under section 410(b)(1)(B). That test provides that plans which cover a fair cross section of employees (that is, plans which cover employees in all compensation ranges and where employees in the middle and lower compensation brackets are covered in more than nominal numbers) satisfy the coverage classification requirements of section 410(b)(1)(B).

We note initially that under section 410(b)(1)(B), qualification of a trust is conditioned on a finding by the Secretary that the classification set up by the employer is not discriminatory. In this area, the Commissioner's finding is "given a shade more than its usual substantial weight." Pepsi-Cola Niagara Bottling Corp. v. Commissioner, 399 F.2d 390, 393-394 (2d Cir. 1968), revg. 48 T.C. 75 (1967). We have held that to prevail on the issue of whether a trust meets the requirements of section 410(b)(1)(B), the taxpayer must show that the Commissioner's determination was arbitrary, unreasonable, or an abuse of discretion. Loevsky v. Commissioner, 55 T.C. 1144 (1971), affd. per curiam 471 F.2d 1178 (3rd Cir. 1973), cert. denied 412 U.S. 919 (1973).

In the situation involved herein, the Plan did not cover employees in all compensation ranges. It failed to cover any lower compensated employees. Thus there was not a "fair cross section" coverage under the Plan of all employees of Hepco.

The consequences of disqualification of the Trust under section 401 are not, however, as harsh as respondent suggests. Of course, the Trust is not exempt from taxation under section 501. However, respondent apparently included in the incomes of the individual petitioners the full amount of contributions made to the Trust on their behalf.¹⁴ Section 402(b) mandates a different result.

Under section 402(b), contributions to a non-exempt trust are included in the gross income of the employee in accordance with section 83, except that the value of the employee's interest in the trust is substituted for the fair market value of the property. Under section 83, transfers to a non-qualified trust are included in an employee's income in the first taxable year in which the employee's rights in the contribution become substantially vested.

Section 1.402(b)-1(b)(4), Income Tax Regs., provides that if an employee's interest in a trust is only partially vested, the amount included in income is the percentage of his interest in the trust which is vested. An example of the calculation necessary to determine the amount of inclusion is contained in section 1.402(b)-1(b)(7), Income Tax Regs.

¹⁴ Respondent's rationale for the figures that appear in the notices of deficiency is not disclosed. The additional compensation charged to Dewey and Doris does not equal the amounts contributed to the Plan on their behalf, yet disqualification of the Plan is the only reason given for additions to compensation income.

Respondent determined, and we agree, that Dewey and Doris had interests in the Trust which are properly includible in income in 1977, 1978 and 1979 and that Nelson had such an interest in 1978 and 1979. However, those interests were only partially vested. The parties, in their Rule 155 computation, can determine the proper amounts of inclusion, bearing in mind that not all of the contributed amounts are includible in income.

Section 83(h) provides that an employer is allowed a deduction under section 162 in an amount equal to the amount included in the employee's income under section 83. The employer's deduction is allowable in the employer's taxable year in which or with which ends the employee's taxable year of inclusion as long as the deferred compensation, together with the non-deferred compensation, is reasonable. Edwin's, Inc. v. United States, 501 F.2d 675 (7th Cir. 1974). We hold that the deferred compensation Dewey, Doris and Nelson received, when added to Nelson's actual salary and bonus and the amount of Dewey's and Doris' salaries and bonuses heretofore found to be reasonable, is the total amount of their reasonable compensation. Accordingly, Hepco is entitled to deductions for the salaries and bonuses of Dewey, Doris and Nelson under section 162 for taxable years 1978 and 1979 in the amounts previously found to be reasonable and also for their deferred compensation, to the extent it is includible in their incomes, as discussed above.

To reflect the foregoing,

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Decisions will be entered
under Rule 155.

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